

Articles

BETTER POSITIONED AGENTS: INTRODUCING A NEW REDEPLOYMENT MODEL FOR CORPORATE BANKRUPTCY LAW

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I. INTRODUCTION

A corporate bankruptcy proceeding—i.e., the government's interference in a firm's course of financial deterioration, which expropriates from a firm and from its shareholders the power to make decisions regarding redeployment of the firm's assets—must simultaneously accomplish two tasks: redeployment of the assets of the financially-distressed firm; and distribution of the proceeds generated to claimants. Of the two tasks, redeployment is, from an economic point of view, the more important decision and has been the subject of much scholarly interest in recent decades. Indeed, optimal redeployment maximizes the wealth of the firm's claimants and, hence, also optimizes social wealth.¹ Law and economics scholars unanimously agree that when

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1. Maximizing the value of the pool of assets reduces the costs of debt capital (the costs of credit), because creditors recover a higher percentage of their debt; which in turn permits firms to fund, ex ante, more good projects with positive net present value (NPV). See, e.g., Mehnaz Safavian & Siddharth Sharma, *When Do Creditor Rights Work?*, 35 J. COMP. ECON. 484 (2007) (concluding that firms have more access to bank credit in countries with better creditor rights and a more efficient court system). In addition, reducing the costs of debt capital creates better incentives to maximize value and therefore maximizes social wealth. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1812-14 (1998). There is also an ex post effect: To the extent that a wrong redeployment decision is made, the value of the firm's assets is reduced, which becomes a social cost since society as a whole bears the loss when assets are not put to their highest valued use. Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1161 (1994) [hereinafter Rasmussen, *Ex Ante Effects*].

redeployment is concerned, there should be no a priori bias toward preserving any set of assets within the boundaries of a single firm.² An optimal bankruptcy procedure should therefore attempt to discern financially-distressed-but-economically-viable firms from financially-and-economically-distressed firms.³ While the former should continue to operate as a going concern, and perhaps undergo a restructuring of its capital⁴ for that purpose; the latter should be shut down, and its assets should be redeployed elsewhere in the economy.⁵

Conventional wisdom has thus far recognized two models to govern corporate bankruptcy decision-making.⁶ The first model, which I will refer to as the "Administrative Model," is based on a process of making a collective decision regarding redeployment, under the supervision of the bankruptcy court. From the viewpoint of efficiency, the most important characteristic of this model is an increased judicial involvement in making

2. The idea of fresh start, which is perhaps the basis for the bankruptcy of individuals, is irrelevant in corporate bankruptcy, since one can always replace one corporate charter with another. Even the preservation of some unique value embedded in a defined set of assets, the "going concern value" of a business, need not be accomplished within a particular company. See Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 519, 521 (1992) (explaining the difference in goals for individuals and business entities in bankruptcy).

3. An economically distressed firm is characterized as a firm for which operating expenses exceed operating revenues, thus inefficiently draining the economy. Michelle J. White, *Corporate Bankruptcy*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 483, 486 (Peter Newman ed., 1998).

4. A restructuring of the firm's capital means either postponement of debt payments, cancellation of debt, conversion of debt into equity interests, or any combination of the three. See MARK J. ROE, *CORPORATE REORGANIZATION AND BANKRUPTCY* 78-79 (2000).

5. Bankruptcy systems try to minimize the number of type-I errors, which occur when inefficient firms are saved, and the number of type-II errors, which occur when efficient firms are shut down. See Michelle J. White, *Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-Of-Court Debt Restructurings*, 10 J.L. ECON. & ORG. 268, 269 (1994) (describing why type-I and type-II errors inevitably occur); Michelle J. White, *Does Chapter 11 Save Economically Inefficient Firms?*, 72 WASH. U. L.Q. 1319, 1319 (1994) [hereinafter M. White, *Does Chapter 11*] (describing the difficulty of determining which firms are economically inefficient).

6. This Article's point of origin is the assumption that the government's intervention in the process of a firm's deterioration towards insolvency—an intervention that goes hand in hand with expropriation of a firm's autonomous decision-making power—is necessary. Such an assumption rejects the argument that the ex ante allocation of control rights over the assets of the firm among its investors is sufficient to assure that redeployment decisions are optimal. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 778 (2002) [hereinafter Baird & Rasmussen, *The End*] (arguing that if control rights are given to investors correctly, the decision to shutdown will be in the hands of those with the best information and incentives to make the decision). This need for a carefully designed arrangement for the allocation of control rights is adopted as a starting point. Thus, the question to be answered is how to devise, within the confines of the collective procedure, an optimal decision-making mechanism to accomplish the redeployment task.

the redeployment decision. This involvement is often criticized as contaminating the decision-making process, since the bankruptcy judge is not a market agent. Corporate bankruptcy literature describes a second market-oriented model, the “Residual Owner Model,” which bases decision-making on tracking down—or according to several variations of this model, even “creating”—the firm’s residual owner, and trusting him with the power to make any decisions regarding the redeployment of the assets of the firm. This description of the two decision-making models is universal: legal systems around the world seem to employ either the Administrative Model or the Residual Owner Model, or a variation of the two.

In this Article, I will introduce a third approach to the redeployment decision, which is based upon the following reasoning: the purpose of the government’s corporate bankruptcy expropriation of shareholders’ decision-making power regarding a firm’s assets could be viewed as an attempt to transfer this power to a unique decision-maker. The designated decision-maker is a market agent whose improved position relative to other agents—his comparative advantage—renders him a superior decision-maker. I will refer to him as “the Better Positioned Agent” (“BPA”). This new approach calls for the BPA to be conferred with the power to decide what to do with the firm’s capital and human assets. The only problem with assigning such an agent this task is that, like all other agents involved in the corporate bankruptcy event, his incentives are not properly aligned to maximize overall wealth; this is why corporate bankruptcy law needs to interfere. The BPA approach reflects an attempt to incorporate important insights from the two existing models, the Administrative Model and the Residual Owner Model, in order to construct an improved decision-making process. While the new approach assumes that decision-making occurs within a basically administrative setting—a mandatory collective procedure run by a bankruptcy court—it nevertheless suggests a way to allocate decision-making power to the market.

The BPA approach is innovative in several respects as a decision-making mechanism for corporate bankruptcy settings. First, the new approach treats corporate bankruptcy decision-making as a process that stretches over time rather than a single event in time. Thus, corporate bankruptcy decision-making consists of several relevant phases during which lawmakers can intervene. Moreover, the new approach demonstrates that corporate bankruptcy’s redeployment decision-making can start prior to the initiation of a formal bankruptcy procedure. Second, the new approach acknowledges that achieving optimal allocation of the distressed firm’s assets requires the fulfillment of several different tasks during the various decision-making phases. Thus, several market agents should be sequentially involved in promoting the efficient deployment of

the firm's assets. Finally, the new approach emphasizes greater reliance upon market mechanisms not only to dominate formal bankruptcy efforts to cope with corporate financial distress, but also to altogether reduce the role played by formal bankruptcy procedures—whether these procedures employ market mechanisms or not—in overcoming problems of corporate financial distress.⁷

The new approach, much like the two prevailing models that precede it, is of course only an imperfect solution. Yet acknowledging its existence could, and should, introduce corporate bankruptcy lawmakers to the problem of which model of three—rather than which model of two—is the best solution. Moreover, acknowledging the existence of the new approach fully exposes some of corporate bankruptcy's actual trade-offs. For example, lawmakers need not compare only the costs of entrusting a judge with the redeployment decision—the Administrative Model—against the costs of auctioning the firm—the Residual Owner Model; but may also add to the comparison the agency costs engendered when utilizing a better positioned market agent.

I will demonstrate the feasibility of the new approach in the context of a dominant secured creditor of a small- to medium-sized firm as a better positioned agent during the period of time prior to the commencement of the formal bankruptcy proceedings. Thus, this Article offers several new insights concerning the treatment of secured creditors in corporate bankruptcy settings and the efficiency rationale justifying erosion of their absolute priority over other creditors. Current literature has already recognized the importance of creating incentives to drive dominant secured creditors to take wealth-increasing actions when maintaining a borrowing relationship with the firm; in general and on the eve of bankruptcy in particular.⁸ Literature has also recognized an efficiency rationale for eroding the secured creditor's full priority over unsecured creditors in cases of the borrowing firm's bankruptcy.⁹ It has been argued that eroding the secured creditor's full priority will, among other things, induce more monitoring of firm behavior. Still, current literature has failed to fully identify the exact way in which a secured creditor, with certain superior skills, can improve efficiency in corporate bankruptcy settings. Thus, this Article suggests that dominant secured creditors of small- to medium-sized firms should, more than anything, be encouraged to curtail the length of

7. The Better Positioned Agent approach is demonstrated in one particular context, leaving attempts to theorize about other contexts to future research. The adoption of the new approach is advocated in a context which considers the secured creditor as a BPA and concerns the period of time prior to the firm's default. This context is unique because applying the new theory at this context can comfortably fit either a pure "Administrative" Modeled bankruptcy procedure or any market-oriented alternative.

8. See *infra* Part IV.B.1.

9. See *id.*

any future formal bankruptcy procedure by gathering information and inducing a turnaround process.

More importantly, notwithstanding the exact task to be performed by the secured creditor, current literature has thus far failed to recognize that a problem of asymmetric information exists between the secured creditor—suspected to have been a better positioned agent and to have possessed superior skills—and any social planner attempting to stimulate proficient secured creditors to take wealth-increasing action. Introducing this new insight sheds light upon the efficiency considerations that affect wealth when dominant secured creditors are encouraged to enhance their monitoring activity, or to increase their influence over the behavior of the borrowing-firm. Simply put, in the bankruptcy world in which only two types of secured creditors exist—those who, by the time a formal bankruptcy procedure commences, have generated a BPA surplus, and those who, by the time a formal bankruptcy procedure commences, have not generated any BPA surplus—it is impossible to ascertain *ex post facto*—by the time a formal bankruptcy procedure commences and the secured creditor's behavior should be sanctioned—whether a particular secured creditor in any given case belongs to the former type or to the latter type. Indeed, sometimes secured creditors are not equipped to take wealth-increasing action, and sometimes there is simply no surplus to be generated by their action. But sometimes secured creditors are well equipped, and a possible surplus does exist, but secured creditors do not have the appropriate incentive to invest in generating the surplus. Being unable to discern between the two types of secured creditors when a formal bankruptcy commences and secured creditors' actions should have already been taken becomes a burden on efficiency, both from an *ex post* perspective and from an *ex ante* perspective. The social engineer—or other creditors, if bankruptcy is considered in a contractual framework—cannot appropriately appreciate efforts by secured creditors to generate a possible BPA surplus, cannot contract in advance with secured creditors to generate any possible BPA surplus, and hence cannot induce secured creditors to create any possible BPA surplus. The result is, in asymmetric information terms, “a lemon's market,” in which only non-BPAs inhabit the market.

In this context of utilizing secured creditors against the backdrop of an asymmetric information problem, this Article suggests that the law can and should offer a screening mechanism to overcome this problem. To be sure, screening secured creditors in order to distinguish between secured creditors who, with regard to any particular firm, have taken action to increase overall wealth from secured creditors who have not done so, enables the carving of a legal rule that induces only efficient secured creditor action. Such a rule thus addresses problems of over- and under-

investment by secured creditors in fulfilling the BPA task.¹⁰ In addition, being able to separate BPAs from non-BPAs minimizes the adverse ex ante effects attributed to any erosion of secured creditors' full priority, as certain secured creditors—BPAs—can actually minimize the erosion of their full priority. And obviously, once screening of secured creditors' types—as BPAs or non-BPAs—becomes obtainable, contracting in advance about this contingency—i.e., the generation of a BPA surplus—also follows.

How is screening of secured creditors who are BPAs from secured creditors who are non-BPAs to be accomplished? Simply put, the required screening mechanism is created as a result of eroding the secured creditor's full priority during the corporate bankruptcy proceeding. In a seminal work which advocated a regime of partial priority for secured claims, Lucian Bebchuk and Jesse Fried have suggested—without addressing the problem raised here of asymmetric information or the need for a screening mechanism—two prototype partial priority rules to replace the conventional full priority rule.¹¹ First, a “fixed-fraction priority rule,” which dictates that a pre-determined fixed fraction of the collateral backing a secured claim—for example, 10%—would be made available to pay the claims of unsecured creditors. Second, an “adjustable-priority” rule, which orders that secured claims be accorded priority only over claims of certain creditors, such as “non-adjusting creditors,”¹² or creditors who have explicitly agreed to be subordinated. Note that any partial priority rule applied in bankruptcy only creates a certain screening effect, albeit an inaccurate one, because applying partial priority rules induces certain secured creditors to attempt an escape from the partial-priority bankruptcy regime. Several capable secured creditors—that is, secured creditors who are BPAs in the sense that they can easily prevent a formal bankruptcy procedure—can escape the adverse effects of such a procedure in this way. Yet the screening accomplished by the partial priority rules suggested so far in literature is not optimal. This Article thus proceeds to introduce a new, third prototype partial priority rule for bankruptcy procedures—a

10. These problems are generated when lawmakers cannot adapt the legal rule—i.e., set the exact extent to which full priority is to be eroded—to fit the exact type of secured creditor.

11. See Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) [hereinafter Bebchuk & Fried, *Uneasy Case*]. See also Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and A Reply to Critics*, 82 CORNELL L. REV. 1279, 1321 (1997) [hereinafter Bebchuk & Fried, *Further Thoughts*] (discussing possible partial priority rules).

12. “Non-adjusting creditors” have been defined as creditors that do not adjust the terms of their loans to reflect the effect on them of security interests which, under a full priority regime, completely subordinate the non-adjusting creditors' claims in bankruptcy. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1295-1304.

“self-dependent priority rule.” This partial priority rule is derived from a new rationale for eroding secured creditors’ priority in a formal bankruptcy procedure. According to the “self-dependent priority rule,” the extent to which a secured claim is accorded full priority or not depends solely upon the actions of the secured creditor himself. Indeed, it is argued that instead of arbitrarily eroding a fixed percentage of the secured creditor’s full priority—and instead of resorting to any other method of full-priority erosion—the law should focus upon eliminating the protections usually awarded to secured creditors during a formal bankruptcy procedure. Corporate bankruptcy law conditions the stay order against the secured creditor’s efforts to foreclose the collateral upon that creditor being awarded two separate protections by the court: “Adequate Protection” against an economic or physical depreciation of the collateral, as a result of risks materializing during the reorganization, such as a fire which erupts and consumes the collateral, or a change in market value;¹³ and protection against temporal or financial depreciation of the collateral—a loss of interest reflecting the time value of money during the time in which the collateral is not liquidated.¹⁴ Denying secured creditors these protections

13. See 11 U.S.C. § 362(a) (2000 & Supp. V 2005) (imposing an automatic stay); 11 U.S.C. § 362(d)(1) (allowing secured creditors relief from the stay to the extent they are denied “adequate protection of an interest in property. . . .”); 11 U.S.C. § 361 (2000) (illustrating the meaning of providing “adequate protection”). Secured creditors have contracted with the firm to provide it with capital in exchange for a superior entitlement compared to other claimants in case the firm defaults, and are promised the benefit of foreclosing and taking away a particular asset of the firm—the collateral—in case such default occurs. The mere commencement of a formal bankruptcy procedure expropriates from the secured creditor the right to determine the exact format upon which to withdraw his claim from the firm, leaving him with a diluted entitlement. This already diluted entitlement, however, needs to be preserved during reorganization attempts. Because extending the secured creditor adequate protection is a pre-condition for moving on with a reorganization, the specific format of the protection—whether by cash payments, by granting the secured creditor an additional or replacement lien in another asset, or otherwise—is determined either at the time reorganization is initially undertaken or when the secured creditor raises such request. See 11 U.S.C. § 361 (2000). See also 11 U.S.C. § 507(b) (2000 & Supp. V 2005) (providing the secured creditor a priority with regard to the part of the secured claim that ex post turned out to be inadequately protected).

14. Corporate bankruptcy law makes, in this context, a distinction between over-secured and under-secured creditors. Under-secured creditors are to be denied post-petition interest, despite the fact that the stay prevents these creditors from foreclosing on the collateral and reinvesting the proceeds elsewhere. *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) (holding that an under-secured creditor is not entitled to compensation for the delay imposed upon him by the stay, which prohibits him from foreclosing on the collateral as soon as a reorganization procedure commences). The reasoning for the Court’s conclusion in *United Savings* was not economic. The Court held that the under-secured creditor owns an “interest in property,” but that interest does not include the right to immediate foreclosure on the collateral. *Id.* This ruling was subject to immense criticism, because of the perverse incentives created when only nominal, rather than real, values of secured claims are protected. Basically, not only does it encourage

during attempts to reorganize the firm¹⁵ becomes a perfectly accurate screening mechanism, as the secured creditor's ability to escape the effects of such a hostile regime becomes directly related to the actions the secured creditor undertakes in order to curb the length of the formal bankruptcy procedure. Since time is a variable in both the secured creditor's erosion-of-priority function and society's loss function, reducing the length of time the formal bankruptcy procedure requires to come to its completion decreases the extent to which the secured creditor's priority is eroded, and also—in immediate direct correlation—society's loss.¹⁶ Moreover, under the terms specified by the "self-dependent priority rule," the secured creditor can compare the marginal cost of "preventing" another time unit—for example, an additional day—of the formal bankruptcy procedure with the marginal benefit of doing so. Thus, this Article offers a contribution to the ongoing debate regarding the efficiency improvements embedded in eroding secured creditors' full priority in bankruptcy.

The discussion in this Article accordingly unfolds in two concentric circles. First, the erosion of secured creditors' protections in bankruptcy is used to demonstrate a new approach to corporate bankruptcy decision-making, the Better Positioned Agent (BPA) approach. Second, the Article

agents to push for a collective procedure in order to attain the benefit of an interest-free use of assets, but it also distorts future-facing investment decisions (in other words, the decision on how to redeploy the assets of the firm). See, e.g., Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287, 347-49 (2003). In contrast to the under-secured creditor, an over-secured creditor is entitled to post-petition interest on his secured claim as provided by the loan contract between that creditor and the firm; and up to the value of the collateral. See 11 U.S.C. § 506(b) (2000 & Supp. V 2005).

15. *In practice*, notwithstanding the arguments raised here, bankruptcy courts do not always award secured creditors the protection against physical depreciation of the collateral. Bebhuk & Fried, *Uneasy Case*, *supra* note 11, at 911-13; James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 143 (2004) [hereinafter J. White, *Death*]. First, bankruptcy courts do not always adhere to petitions by secured creditors to be awarded adequate protection. Second, since awarding adequate protection relies on estimates made by the bankruptcy court—for example, the probability that a particular asset serving as collateral shall depreciate in value over time—the court can produce biased or manipulative estimates, the result of which is abstention from any kind of ruling that conditions the progress of the reorganization process upon the secured claim being adequately protected. Notwithstanding the reasons driving it, is this practice efficient? I will argue in this Article that at least sometimes the practice of denying secured creditors *all* protections during a formal bankruptcy proceeding is efficient, as it corresponds to an opportunity to improve the redeployment of assets of certain financially distressed firms.

16. Note that any protection the secured creditor enjoys in bankruptcy is paid by lower-ranking claimants and that society's loss also includes the undesirable effects of a long, formal bankruptcy procedure upon various agents.

offers a contribution to the ongoing debate regarding the efficiency improvements embedded in eroding secured creditors' full priority in bankruptcy.

The Article proceeds as follows: Part II describes the relevant theoretical framework, as it depicts two possible decision-making models for corporate bankruptcy settings. First, the Administrative decision-making Model, currently serving as the prevailing instrument in most countries, is presented with a discussion of the arguments both for and against reliance upon this model. Second, the Residual Owner decision-making model is presented with arguments for and against reliance upon this model. Part III introduces the contours of a third new approach to striking the redeployment decision. The new approach assigns the bankruptcy court with the ability to allocate decision-making power to several agents, according to each agent's comparative advantage during different periods in time. The advantages of the Better Positioned Agent model are then briefly surveyed. Part IV demonstrates the feasibility of the Better Positioned Agent approach in one context, that which concerns a dominant secured creditor's ability to dominate the redeployment of assets of a small- to medium-sized firm prior to the commencement of a collective bankruptcy procedure. This Part begins with a depiction of the relevant economic background. Then, the focus shifts to utilizing the secured creditor as a better positioned agent. Previous attempts by scholars to describe the secured creditor as a superior decision-maker, as well as prior arguments concerning the idea that the secured creditor's full priority should be eroded for that end, are reviewed. Having defined a new task for the secured creditor, which is relevant to enhancing the efficiency of corporate bankruptcy decision-making, three impediments to employing the secured creditor to accomplish that task are discussed: first, the inherent problem of asymmetric information that burdens the utilization of the secured creditor as a BPA, along the screening solution which lawmakers can adopt to solve the problem; second, the prospect of employing a secured creditor of financially distressed firms as a BPA; and third, the ex post and ex ante costs of employing the secured creditor as a BPA and eroding its priority in bankruptcy.

II. TWO PREVAILING REDEPLOYMENT MODELS

A. *Administrative Decision-Making*

1. The Model

The most prevalent model of a mandatory redeployment decision-making mechanism is the court-supervised corporate bankruptcy

reorganization procedure. The classic example is the American Chapter 11, the most celebrated administrative bankruptcy procedure. The Administrative Model's roots are found in a bankruptcy model of purely administrative nature, according to which one person alone, the bankruptcy judge, makes all relevant decisions, including those regarding the redeployment of the firm's assets. In its more modern form, the model focuses on a process for obtaining a redeployment decision, which is initiated either voluntarily or involuntarily,¹⁷ and managed under the auspices of a stay imposed on all claimants' individual collection efforts against the firm.¹⁸ According to the Administrative Model, the initiation of a bankruptcy procedure marks the commencement of an interim period during which the redeployment decision is contemplated. The luxury of this time period is sometimes made possible by an injection of new financing that allows the firm to continue operating its business. A court-appointed agent, either incumbent management¹⁹ or a trustee, manages the firm's business.²⁰ But, most importantly, during this interim time period, the bankruptcy court may enable and encourage structured bargaining among classes²¹ of the firm's claimants.²² Such bargaining is meant to produce a decision regarding the redeployment of the firm's assets; but, as

17. Voluntary initiation of bankruptcy originates in the firm. In the United States involuntary petitions of bankruptcy are discouraged in various ways. As a result, few cases are initiated involuntarily. See Michelle J. White, *The Costs of Corporate Bankruptcy: A U.S.-European Comparison*, in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 467, 469 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996) [hereinafter M. White, *Costs*].

18. Under the terms of Chapter 11, the stay is automatic. See 11 U.S.C. § 362 (2000 & Supp. V 2005). In other jurisdictions, such as the United Kingdom, the bankruptcy judge enjoys discretion to impose a stay or not. See Insolvency Act, 1986 § 8(1). In this respect alone, the latter regime is more vulnerable to weaknesses to be immediately specified.

19. Chapter 11 usually entrusts the formulation of a reorganization plan for cases which are not "small business" solely in the hands of the debtor in possession for a period of 120 days, followed by an additional 60 day period designated to allow the debtor in possession to obtain claimants' acceptance of the plan, and then further extensions if deemed necessary. This is the "exclusivity period." See 11 U.S.C. § 1121 (2000 & Supp. V 2005). A trustee is appointed to replace incumbent management only in cases of fraud, dishonesty, incompetence or gross mismanagement by these managers, or when the interests of creditors and equity holders mandate such an appointment. See 11 U.S.C. § 1104(a) (2000). Nevertheless, when sent to liquidation under Chapter 7, a trustee is appointed, although he might hire the old managers. See 11 U.S.C. § 721 (2000 & Supp. V 2005).

20. Under the terms of Chapter 11, incumbent management is usually left to run the firm, and is called a "debtor in possession." See 11 U.S.C. §§ 1101(1), 1107 (2000).

21. See, e.g., 11 U.S.C. § 1123 (2000 & Supp. V 2005).

22. For example, one requirement for reorganization is that at least one class of impaired claimants accepts the reorganization plan. See 11 U.S.C. § 1129(a)(10) (2000). Fulfillment of this requirement indicates that some "give and take" occurred among claimants. See David T. Brown, *Claimholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law*, 2 REV. FIN. STUD. 109 (1989) (providing a more formal treatment of the reorganization game).

reality dictates, bargaining also concerns the question of distribution of existing and future-generated value expected to be derived from the new redeployment decision. The negotiated scheme combines a decision regarding redeployment and a capital restructuring decision, and is then put forward as “a reorganization plan.” A typical scheme reflects a painful capital restructuring decision: most classes of claimants are to receive only a fraction of their claims. Thus, under the terms of the Administrative Model, reorganization, rather than liquidation alone,²³ of the financially distressed firm is permitted by the court; but it is conditioned upon acceptance of the reorganization plan by each class of the firm’s claimants in a supermajority vote.²⁴ In other words, the firm’s claimants collectively, and roughly, refine a redeployment decision.²⁵

Judicial intervention is an important component of the model and is exercised throughout the process of running the collective procedure.²⁶ Special mechanisms are implemented in order to increase chances that a good decision will be made by the judge,²⁷ nevertheless, it is ultimately the judge’s decision. For example, the final decision on whether or not to allow reorganization is entrusted solely to the bankruptcy judge, who can convert a Chapter 11 case to a Chapter 7 case.²⁸ Consider another example: at the end of the process, under certain conditions, the court possesses the power to either disqualify a reorganization plan, if the plan had been

23. The existence of a liquidation path is undisputable, and indeed all countries have a liquidation alternative, which means the firm is sold for cash, either as an ongoing concern or piecemeal. In the United States, liquidation is usually carried out under Chapter 7 of the Bankruptcy Code. The only question troubling lawmakers around the world is whether another alternative should exist besides liquidation, i.e., reorganization.

24. For example, Chapter 11 requires approval by each class of creditors by a majority of holders of at least two-thirds in amount and more than one-half in number of the allowed claims. Shareholders need to approve the plan in a majority of two-thirds of the shares. A class left unimpaired under a plan, and each of its members, are presumed to have accepted the plan. A class of creditors is deemed not to have accepted a plan if such plan provides that the class receives no value whatsoever. See 11 U.S.C. § 1126 (2000).

25. Each claimant’s estimate of what a good redeployment would constitute, which is based on the information he holds, contributes to a collective decision; however, the process is manipulated by those holding the right to propose a reorganization plan. The more complicated it is to construct a plan, the more “take it or leave it” the plan becomes. Changing details within a plan would delay the process, and thus increase its costs.

26. Cf. Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356 (2001) (discussing why having a bankruptcy judge control the reorganization process is not ideal).

27. For example, the judge is required to make sure that secured creditors, whose individual collection efforts against the secured assets are stayed in order to allow a reorganization to succeed, are awarded “adequate protection”. See *supra* notes 14-15 and accompanying text. Protecting the true value of the securities is a mechanism that assures that only firms which need to be maintained as a going concern would enter the process of reorganization.

28. See 11 U.S.C. § 1112(b) (2000 & Supp. V 2005).

rejected by some of the firm's impaired claimants,²⁹ or confirm a plan despite overflowing objection.³⁰ An example of the first category, which mandates exclusion of a proposed plan and is found in the Chapter 11 case, is established in case a plan is rejected by a class of creditors that is made worse off under the terms of the plan compared to the result of a hypothetical liquidation of the firm's assets.³¹ Another statutory cause for non-confirmation of a plan under Chapter 11 emerges when a proposed plan "freezes out" a non-consenting class of creditors. A reorganization plan "freezes out" an impaired class of creditors that voted to reject it when the plan does not adhere to the absolute priority rule; value is extended according to the plan to a lower-ranking class, despite the fact that the opposing higher-ranking class is not being paid in full.³²

On the other hand, the court can use a variety of means to bring about the approval of a plan despite eminent objections to it. A "cram down" on a class of objecting creditors is an option.³³ In other jurisdictions, the good faith requirement of a claimant's vote, for example, can serve to squash a single creditor's objection to a plan. Finally, courts possess informal means. For example, they can manipulate the process of classification of claimants for voting purposes and the judge's personality can significantly affect the redeployment decision.³⁴ Bankruptcy judges often consider themselves captains of a periled ship, with navigation to the safe shore of continuation of the firm's business being their ultimate goal.

29. See 11 U.S.C. § 1124 (2000 & Supp. V 2005) (discussing the conditions of when claims are to be considered impaired).

30. See 11 U.S.C. § 1129 (2000 & Supp. V 2005). The plan can of course be unanimously confirmed. In other words, two plan confirmation paths are available: the first is a unanimous consent path, and the second is a confirmation path called a "cram down."

31. This is the "best interests test." See 11 U.S.C. § 1129(a)(7) (2000) (creating protection for individual dissenting claimants). Estimating what a liquidation of the firm would generate requires the court to evaluate the firm's assets.

32. This is the "fair and equitable" requirement, satisfaction of which can enable the court to "cram down" on a class of impaired creditors objecting to a proposed plan. See §§ 1129(a)(8), 1129(b). Another important requirement under the bankruptcy code is the feasibility of the plan. See 11 U.S.C. § 362(d)(2) (2000 & Supp. V 2005). A requirement (related to adherence to the absolute priority rule) which does not exist under the American Bankruptcy code is that a senior class does not receive more than full payment of its debt when lower classes are not paid in full.

33. See 11 U.S.C. § 1129(b) (2000 & Supp. V 2005). See also Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).

34. See Jocelyn Evans, *The Effect of Discretionary Actions on Small Firms' Ability to Survive Chapter 11 Bankruptcy*, 9 J. CORP. FIN. 115 (2003) (describing how some pro-creditor decisions, especially a decision to reduce the exclusivity period, in the reorganization of closely-held firms tend to decide the outcomes of an Administrative Modeled bankruptcy). A judge's pro-creditor inclination was found to reduce the chances of the firm to survive. *Id.*

However, in the absence of unanimous claimants' consent on any future step within bankruptcy, and in order to evoke or reject any grounds³⁵ for judicial intervention either in the process of granting a non-automatic stay or in the integrity of the bargaining process or the bargained plan, the supervising court needs to conduct a very difficult, expensive, and error-prone preliminary inquiry to determine the firm's value.³⁶ The court needs to evaluate, sometimes on an almost daily basis,³⁷ the prospects of the firm. This is the problem of judicial valuation.³⁸ The difficulty in performing such a task is explained:

Valuing a firm's assets is a tricky business. One must project how much income can be derived from the assets in their current use and alternative uses and discount all these to present value. The value of assets may depend on much that is uncertain. It may also depend on information that is hard to obtain. As a result, third parties may underestimate a firm's chances for success. On the other hand, they may overestimate them.³⁹

Valuation is the key element in performing the task of judicial supervision of the reorganization process, since the value attached to the firm determines where, down the rank of claimants, it is necessary to stop and wipe out all lower ranking claims.⁴⁰ This seemingly simple decision, which claim should be discharged and not survive the reorganization, lies at the basis of every redeployment conflict among claimholders. Indeed, if the firm were to be liquidated rather than reorganized, this conflict would disappear because the revenues collected from selling the firm's assets to a third-party buyer in liquidation would be distributed to the firm's claimants

35. Consider the requirement that the reorganization plan adhere to the absolute priority rule. A reorganization plan might award shareholders of the firm shares in the reorganizing firm, even though unsecured creditors receive nothing, in exchange for an infusion of new value to the reorganizing firm. Indeed, sometimes shareholders' participation is a condition for the added value of reorganization to be captured. See *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999). Since non-bankruptcy rights need to be preserved, and freeze-out of unsecured creditors is precluded, the court must engage in evaluating the firm's worth in a liquidation scenario.

36. Knowing how much the firm is worth is necessary in order to also decide the value of each creditor's claim against the firm; for example, to examine what a creditor would receive in liquidation. See Royce De R. Barondes, *Reorganizations and Stochastic Collateral Value*, 11 S. CAL. INTERDISC. L.J. 193, 194-95 (2002).

37. When the stay is granted upon discretion, its length depends on the court's decision, and hesitating courts might postpone their final redeployment decision by granting a stay for the interim period, while waiting for further information and developments.

38. See Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 143-44 (1986) [hereinafter Baird, *The Uneasy Case*] (describing a valuation problem regarding intangibles).

39. *Id.* at 136.

40. See Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 778 (1988) [hereinafter Bebchuk, *New Approach*].

according to the absolute priority rule, and holders of “underwater claims” would receive nothing and be wiped out as a matter of course. Liquidation thus supplies an objective number, that of the market, to represent the value of the firm. Reorganization, the hypothetical sale of the firm to its claimholders, necessitates either a bargained or a judicial subjective decision regarding the firm’s value, which in turn decides whose claim is not to be exchanged for rights (“tickets”) against the new reorganized firm.⁴¹

Also, even if no judicial involvement occurs, the difficulties of valuing the firm manifest in the bargaining process. Even if all claimholders have their interests aligned, they have to make a very difficult redeployment decision together, which depends on their estimate of whether the decline in the value of the firm and its cash flow is temporary, in a manner solvable by capital restructuring, or permanent, in a manner that requires a major change of operations including a possible complete shut down.⁴² Matters are only made worse when the interests of the negotiating parties are not aligned, as is often the case, and information and agency problems encumber the process of making such a decision.⁴³ To demonstrate the former problem, note that although firms in bankruptcy must comply with certain disclosure requirements, they sometimes cease, on the one hand, to supply investors with audited financial statements, while on the other hand, managers have a clear incentive to supply only positive information on the firm or interpret information in a positive manner.⁴⁴

The American Chapter 11 is, as already mentioned, a classic example for an Administrative decision-making Model. But a similar model is commonly found in many Western countries as well, although it differs in form and detail.

2. The Case against Administrative Decision-Making

Scholars have been arguing for over fifteen years about the shortcomings of the Administrative Model. First of all, running an administrative bankruptcy procedure has been shown to take too much

41. *Id.*

42. See Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines*, 48 J. FIN. ECON. 55, 57 (1998).

43. See Karen Hopper Wruck, *Financial Distress, Reorganization, and Organizational Efficiency*, 27 J. FIN. ECON. 419, 422-24 (1990). See also *infra* notes 52-53 and accompanying text.

44. See Weiss & Wruck, *supra* note 42, at 57-58.

time.⁴⁵ While reorganizing the firm might cut the time and expenses needed to find buyers for the firm's assets,⁴⁶ the reorganization process itself requires significant time and expense.⁴⁷ Bargaining among claimants is conducted for two diverse issues: redeployment and distribution.⁴⁸ The issue of waiving special bankruptcy protections awarded by the court is also subject to bargaining.⁴⁹ These features manifest in a lengthy and tiring process of negotiations, which involves substantial dickering and haggling—all derived from conflicting incentives⁵⁰—resulting in immense

45. The average time spent by large, publicly-held firms in bankruptcy was found to be 18 months. See Edward I. Altman, *Evaluating the Chapter 11 Bankruptcy-Reorganization Process*, 1993 COLUM. BUS. L. REV. 1, 3-4 (1993) (describing how smaller firms complete the bankruptcy process quicker than larger firms). See also Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 744 n.65. (1993) [hereinafter LoPucki, *Trouble*].

46. See Baird, *The Uneasy Case*, *supra* note 38, at 140-41.

47. See Ulrich Hege, *Workouts, Court-Supervised Reorganization and the Choice Between Private and Public Debt*, 9 J. CORP. FIN. 233, 254-55 (2003).

48. See Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 634 (1993) [hereinafter Baird, *Revisiting*]. Some have argued that this failure of the Administrative Model to separate the issues of how to reorganize and how much each claim should be reduced is the main cause for a worldwide common dissatisfaction with Administrative Model bankruptcy laws. See Philippe Aghion, Oliver Hart & John Moore, *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 858-61 (1994) [hereinafter Aghion et al., *Improving*] (asserting that one of the biggest problems with bankruptcy laws is that it miscalculates how the reorganization process should be conducted); Oliver Hart et al., *A New Bankruptcy Procedure that Uses Multiple Auctions*, 41 EUR. ECON. REV. 461, 463 (1997) (arguing that the main reason for the worldwide dissatisfaction with bankruptcy laws is the inability of the laws to separate issues of liquidation efficiency and distribution). However, a different view of the bargaining process argues that the subject of negotiations is not the question of whether to liquidate or reorganize, but rather, is only the question of distributions. See Samuel L. Bufford, *What is Right about Bankruptcy Law and What is Wrong about Its Critics*, 72 WASH. U. L.Q. 829, 844-45 (1994).

49. See Baird, *The Uneasy Case*, *supra* note 38, at 145 (noting that from an economic viewpoint, bargaining over bankruptcy rights rather than substantive rights, is a total waste).

50. Shareholders have an incentive to argue that the firm is merely suffering from temporary financial distress but is economically viable because they would like the agreed-upon value of the firm to increase, thus enabling them to be part of the reorganization; creditors would like to reorganize without the shareholders so they argue that the firm is economically non-viable and of low value. Managers would side with the party less likely to fire them. To illustrate, assume that before entering bankruptcy the firm owed \$7 million to secured creditors and \$7 million to unsecured creditors. Assume further that the suggested reorganization plan would include the issuance to claimants of equity in the new, reorganizing firm in exchange for pre-bankruptcy debt. Secured creditors would like the firm to be valued at \$7 million or less (lines #1 or #2 in the table). At that value they would obtain ownership over the entire reorganized firm. Unsecured creditors would like the firm to be valued at exactly \$14 million (line #4 in the table), thus enabling them to receive the maximum of 50% of the shares of the reorganizing firm. Shareholders would like the firm to be valued as high as possible (line #6 in the table). See, e.g., Wruck, *supra* note 43, at 422-24.

time-dependent procedural costs.⁵¹ Manipulation and game playing by the negotiating parties are ubiquitous.⁵² A severe agency problem manifests itself when lawyers and other professionals, whose compensation increases with the length of the collective procedure, have little incentive to push for a swift process.⁵³ A recent study illustrating this problem revealed that Chapter 7 cases last almost as long as Chapter 11 cases.⁵⁴

A survey conducted by the airline industry provides an interesting indication of the poor performances of bankrupt firms involved in court-supervised procedures.⁵⁵ A sample of commercial aircraft transactions conducted from 1978 to 1991, consisting of twenty-seven major United States airlines, eight of which went bankrupt, showed that bankrupt airlines sold assets at greater discounts—averaging between 14% and 46%—than distressed but non-bankrupt carriers.⁵⁶ Furthermore, in this context, no significant differences were found in discounts offered within reorganization proceedings compared to discounts offered within liquidation proceedings.⁵⁷ This supports the contention that reorganization is preferable to liquidation. One might argue then, that the firm's formal

#	Firm Value (in millions)	Secured creditors' % of reorganized firm	Unsecured creditors' % of reorganized firm	Shareholders % of reorganized firm
1	\$3	100%	0%	0%
2	\$7	100%	0%	0%
3	\$10	70%	30%	0%
4	\$14	50%	50%	0%
5	\$16	43.75%	43.75%	12.5%
6	\$20	35%	35%	30%

51. Indeed, as Professor Baird said, "The greatest weakness of a corporate reorganization may be what is often advanced as its greatest strength—that it promotes bargaining" Baird, *The Uneasy Case*, *supra* note 38, at 145. See also Ben Branch, *Streamlining the Bankruptcy Process*, 27 FIN. MGMT. 57, 57 (1998) (illustrating the difficulties: "Anyone who has served on a creditors' committee in a large bankruptcy will understand the contentious nature of the current process. The debtor is likely to be suspicious of the creditors and reluctant to share nonpublic information. Different creditor groups are suspicious of each other and the debtor. Lawyers are hired to check the work of other lawyers. Accountants are hired to check the work of other accountants. Investment bankers look over each other's shoulders. Everyone negotiates for maximum individual advantage. Making the pie larger gets lost in the process of fighting over how to divide it.").

52. See Baird, *The Uneasy Case*, *supra* note 38, at 128.

53. Baird remarked that under current Chapter 11 law, the duties of those in control of the firm are not adequately defined. See Baird, *Revisiting*, *supra* note 48, at 640-41, 645.

54. See Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. FIN. 1253, 1301 (2006).

55. See Todd C. Pulvino, *Effects of Bankruptcy Court Protection on Asset Sales*, 52 J. FIN. ECON. 151, 151-52 (1999).

56. See *id.* at 153, 155, 178-79.

57. See *id.* at 179.

in-bankruptcy status by itself not only attracts opportunistic buyers with “seductive” low offers, but might also influence the business judgment of decision-makers.

Second, it had been argued that the Administrative Model is inefficient because of its reliance on the subjective valuation of the firm. It has been particularly argued that judges, who enjoy a great deal of discretion⁵⁸ and whose involvement is crucial,⁵⁹ are relatively ill equipped to cope with the question of valuation. In light of judges’ immense responsibility and their tremendous influence on the process of redeployment in bankruptcy, one would expect most bankruptcy judges to be experts in business strategy and valuation or be able to master evidence from outside experts and the market.⁶⁰ However, most judges are often neither.⁶¹

But the problem is deeper. Judges do not put their money at stake when performing the valuation inquiry.⁶² Therefore, they lack the incentive that drives a third-party buyer of the firm’s assets who will bear all of the consequences of value estimates.⁶³ Moreover, judges are not submitted to the market’s natural screening process that market agents are, where only those making good decisions survive.⁶⁴ Absent similar competitive constraints, such as those imposed on market agents, judges are more likely to underestimate risks.⁶⁵ Furthermore, “judges . . . are considerably more

58. See *In re Evans Prods. Co.*, 65 B.R. 870, 875-76 (S.D. Fla. 1986) (illustrating the discretion judges have in evaluating a debtor’s worth). See also William C. Whitford, *What’s Right about Chapter 11*, 72 WASH. U. L.Q. 1379, 1402 (1994) (giving examples of judges’ discretions during a bankruptcy proceeding).

59. See Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, *Valuation of Bankrupt Firms*, 13 REV. FIN. STUD. 43, 44 (2000) (indicating that “[i]n practice, both valuation hearings and competing [reorganization] plans are relatively uncommon in large public company bankruptcies. In general, the cash flow forecasts and the values they imply arise from judicial weighting of competing economic interests.”).

60. See Weiss & Wruck, *supra* note 42, at 59.

61. This problem worsens in countries whose judicial systems are inefficient or corrupt, or whose bankruptcy laws are underdeveloped and vague. See Hart et al., *supra* note 48, at 463.

62. See Baird, *The Uneasy Case*, *supra* note 38, at 136-37.

63. See *id.* at 136.

64. See Baird & Morrison, *supra* note 26, at 366-67. See also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 100 (1991) (“Judges are neither chosen for business acumen nor fired or subject to reductions in salary if they err in assessing business situations.”).

65. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 220-21 (1986). See also Baird, *The Uneasy Case*, *supra* note 38, at 137 n.14 (arguing that bankruptcy judges have tended to overvalue firms in bankruptcy); Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573, 587 n.40 (1998) (relying on the Endowment Effect and cognitive psychology literature to support the argument). A debate regarding judges’ competence to implement bankruptcy policies also has taken the form of a

susceptible to judgment errors in complex disclosure disputes, where the allegedly misleading information is 'soft,' speculative, or predictive in nature."⁶⁶ Sympathy towards claimants holding underwater claims stimulates judges to overvalue firms.⁶⁷ Finally, judges are compelled to avoid actual events and sources of information, as they do not participate in actual negotiations or converse privately with the parties.⁶⁸

Judges are therefore less likely than market agents—buyers or shareholders—to value the firm "correctly."⁶⁹ Even if judges are assumed to surpass feeding on information supplied to them by experts and interested parties in an adversarial context, it is still hard to acknowledge any kind of advantage enjoyed by judges, simply because it is possible that these information sources themselves are not perfect.⁷⁰

The inaccuracy of judicial valuation is enhanced by a problematic supply of information, limited both in amount and quality, due to deteriorating market involvement in its provision.⁷¹ For example, shares of publicly-held firms in bankruptcy are often not traded during bankruptcy,⁷² and equity analysts reduce their coverage of firms in formal bankruptcy.⁷³ In a study exploring the relation between the market value of sixty-three publicly traded firms emerging from Chapter 11, the dispersion of valuation errors was found to be very wide—the sample ratio of estimated value to market value varied from less than 20% to greater than 250%.⁷⁴ In

proceduralist versus traditionalist controversy. See Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559 (2001).

66. Eric Talley, *Disclosure Norms*, 149 U. PA. L. REV. 1955, 1957 (2001). Even impartial adjudicators may err in such contexts, having first to reconstruct and interpret the often-technical language that attends such disclosures and then to assess the ultimate accuracy of such statements long after the fact. These tasks are not easy for judges and juries, who generally possess neither technical familiarity with the underlying issues nor any direct knowledge of the actual context in which the initial disclosures were made. See Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 572-76 (1998) (describing problems of hindsight bias that frequently plague retrospective legal assessments on technical matters).

67. See Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 547-48 (1983).

68. See Baird & Morrison, *supra* note 26, at 367.

69. See Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 EMORY BANKR. DEV. J. 319, 326 (1991) [hereinafter Rasmussen, *Efficiency*] ("It is hard to believe that judges can outguess the New York Stock Exchange regarding the value of distressed companies. If they can, they are in the wrong line of work and should be stock traders.").

70. See *id.* For example, even if sources of information differ in reliability, the judge cannot distinguish among them. Note, however, that this last argument might prove the general case for preferring a market decision-making mechanism and not merely highlight judges' shortcomings in valuing distressed firms.

71. See Gilson et al., *supra* note 59, at 45.

72. See *id.* at 60.

73. See *id.* at 61-63.

74. See *id.* at 44-45.

other words, the valuation estimates of these firms were quite imprecise, more like “a guess compounded by an estimate.”⁷⁵

A third deficiency identified by scholars in administrative bankruptcies is demonstrated by distributional tendencies,⁷⁶ such as violation of the absolute priority rule in reorganization plans approved by courts.⁷⁷ The most observed violation occurs when equity holders receive value according to the plan, despite the fact that more senior creditors are not paid in full.⁷⁸ Indeed, redistribution of wealth in bankruptcy is ever-present. However, the efficiency of absolute priority rule violations, which generally occur because the system encourages settlement,⁷⁹ is a source of controversy.⁸⁰ Empirical analysis is inconclusive regarding whether the involvement of bankruptcy judges in the process of reorganization facilitates deviations from the absolute priority rule.⁸¹

A fourth weakness purported by scholars emanates from the fact that, in some legal systems’ administrative procedures, a firm’s management is

75. Lynn M. LoPucki, *Comment: Stakeholder Interests and Bankruptcy*, 43 U. TORONTO L.J. 711, 712 (1993) [hereinafter LoPucki, *Comment*].

76. See Thomas H. Jackson, *Comment on Baird, “Revisiting Auctions In Chapter 11”*, 36 J.L. & ECON. 655, 656-57 (1993).

77. See Julian R. Franks & Walter N. Torous, *Lessons from a Comparison of US and UK Insolvency Codes*, 8 OXFORD REV. ECON. POL’Y. 70, 79-80 (1992); Hege, *supra* note 47, at 256-57; Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APPLIED CORP. FIN. 13, 29-31 (1991).

78. See Lucian Arye Bebchuk, *Using Options to Divide Value in Corporate Bankruptcy*, 44 EUR. ECON. REV. 829, 833 (2000) [hereinafter Bebchuk, *Using Options*].

79. See Francesca Cornelli & Leonardo Felli, *Ex-Ante Efficiency of Bankruptcy Procedures*, 41 EUR. ECON. REV. 475, 480-81 (1997) (discussing differences in this context between Britain’s bankruptcy system and America’s Chapter 11 process). These systems differ with regard to the identity of the person proposing the reorganization plan. Under the terms of Chapter 11, junior claimholders may offer a plan to which senior claimholder can agree or disagree. According to British law, however, senior claimholders make all offers, to which junior claimholders can agree or disagree. *Id.*

80. See Aghion et al., *Improving*, *supra* note 48, at 853-54 (explaining the desirability of absolute priority rules); Lucian Arye Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445 (2002) [hereinafter Bebchuk, *Ex Ante Costs*] (arguing that absolute priority rules have negative effects on decisions made by shareholders ex ante). For example, deviating from the absolute priority rule might mitigate: (a) the shareholder’s incentive to delay the firm’s entrance to the collective procedure and curb redeployment; and (b) the impetus to gamble the firm’s assets on the eve of bankruptcy. See also Paul Povel, *Optimal “Soft” or “Tough” Bankruptcy Procedures*, 15 J.L. ECON. & ORG. 659, 661, 679 (1999) (claiming that a bankruptcy law is optimal if it would replicate the optimal contract between parties in a transaction-cost-free environment and that either tough or soft procedures have potential to meet that condition, while noting that mixed procedures might be worse than either of those pure processes).

81. See Evans, *supra* note 34, at 127 (showing how pro-creditor decisions made by bankruptcy judges increased the likelihood of deviations from the absolute priority rule. Pro-debtor decisions, on the other hand, were not found to impact the likelihood of such deviations).

retained when attempting to reorganize it.⁸² Supporters of this practice argue that incumbent managers are already familiar with the intricacies of the firm's production unit; making them better candidates to run the firm while a proper redeployment path is determined, thereby increasing the chances of a successful reorganization.⁸³ Others contend, however, that retained management might abuse creditors and misuse the protections awarded by the court to make bad investment decisions.⁸⁴ Moreover, managers inherently prefer reorganization of the firm to liquidation, since reorganization allows them to retain their jobs and effectuate a wealth transfer from creditors to the firm's shareholders.⁸⁵ Furthermore, when managers represent current shareholders—or when the owners of the firm manage it—they have an incentive to take high risks and even gamble the firm's assets.⁸⁶ The court's supervision can only slightly mitigate this tendency.⁸⁷ In addition, management's inclination to abuse the bankruptcy procedure is sometimes supported by courts.⁸⁸

Although management misbehavior should be relevant primarily to publicly held companies whose ownership and control rights are divided, it is also a factor that has been presented by Bradley and Rosenzweig as a justification for a sweeping repeal of Chapter 11.⁸⁹ To prove their point, Bradley and Rosenzweig present data gathered on companies before and

82. In Chapter 11 terms, the firm's management becomes "debtor in possession". See *supra* text accompanying note 19.

83. See Michael Bradley & Michael Rosenzweig, *The Untenable Case For Chapter 11*, 101 YALE L.J. 1043, 1044 (1992); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 694 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*].

84. See Bradley & Rosenzweig, *supra* note 83, at 1045; Joseph E. Stiglitz, *Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-overs*, 3 BELL J. ECON. MGMT. SCI. 458, 471-72, 480 (1972). See also Erica M. Ryland, *Bracing for the "Failure Boom": Should a Revlon Auction Duty Arise in Chapter 11?*, 90 COLUM. L. REV. 2255, 2258-63 (1990) (describing the details of legal arrangements under Chapter 11 that create management agency costs).

85. Bradley & Rosenzweig, *supra* note 83, at 1045-46; Hege, *supra* note 47, at 258-59.

86. LoPucki, *Trouble*, *supra* note 45, at 732-34. When the firm is insolvent, its owners stand to gain everything if their gamble succeeds and lose nothing if it fails, since their shares are nearly worthless when the bet is made. Assume, for example, that the firm has \$1 million in assets, and liabilities of \$1.2 million. In that case it would be rational from the owner's perspective to bet the firm's assets on a flip of a coin, even if such a bet were a bad one from the firm's point of view.

87. *Id.* at 736-37. For example, the owners can try a new product or a new marketing concept or fight a worker's union.

88. Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11 (1991) [hereinafter LoPucki & Whitford, *Venue Choice*]. Courts tend to be pro-management whenever competition over venue of bankruptcy filing arises among jurisdictions.

89. Bradley & Rosenzweig, *supra* note 83.

after Chapter 11 was introduced in 1978 to show that companies filing under Chapter 11, although financially stronger than those that had filed for bankruptcy before Chapter 11 was legislated,⁹⁰ nevertheless demonstrated a significantly higher percentage of equity losses and debt security value.⁹¹

Some bankruptcy scholars were quick to respond to this provocative argument and their reply was decisive: although driven by perverse incentives to a certain extent, managers are hardly as powerful, or necessarily as nefarious, as Bradley and Rosenzweig have described them.⁹² Moreover, bankruptcy scholars contend that not only do managers of financially-distressed firms find no benefit from the reduction in creditor and shareholder recoveries in Chapter 11 reorganizations;⁹³ they actually face an ever increasing danger of losing their jobs.⁹⁴ The data presented by Bradley and Rosenzweig suggests otherwise, of course, though their methods of statistical analysis have been challenged.⁹⁵ Another argument against their assertions is that managers during bankruptcy are prone to make poor decisions simply because of heavy conflicting pressures that paralyze their thought processes, thus their suboptimal decisions do not clearly evince selfish subterfuge of firm interests.⁹⁶

90. The previous American bankruptcy regime was dictated by either Chapter X (for public companies) or Chapter XI (for private companies) of the Chandler Act. Chapter X required the appointment of a trustee to manage the firm and relied heavily on the Security Exchange Commission (SEC) to oversee the process. Chapter XI allowed for incumbent management to remain in office throughout the case, giving the SEC no role.

91. Bradley & Rosenzweig, *supra* note 83, at 1063.

92. See, e.g., Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79, 81, 94-97 (1992) [hereinafter LoPucki, *Strange Visions*]; Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992).

93. LoPucki, *Strange Visions*, *supra* note 92, at 95.

94. *Id.* at 95-96 nn.52, 55 (containing a list of relevant studies empirically supporting the "weak managers" proposition). See also Edith Shwalb Hotchkiss, *Postbankruptcy Performance and Management Turnover*, 50 J. FIN. 3 (1995). In addition, new management hired during reorganization to replace old management was found to align their interests with those of creditors. See Whitford, *supra* note 58, at 1383-84.

95. One argument contended that the data presented by Bradley and Rosenzweig was not only questionably assembled, but can also be explained by the fact that companies reorganized after 1978 were more leveraged due to the contemporaneous emergence of the "junk bond" era. See LoPucki, *Strange Visions*, *supra* note 92, at 80, 82-94.

96. Whitford, *supra* note 58, at 1385. Note, however, that once a trustee is appointed to manage the firm in bankruptcy—or involuntary filing of bankruptcy is taken into consideration, as the case is in many jurisdictions and sometimes under Chapter 11—the set of problems changes. Management misbehavior becomes less of a problem, but another complication might emerge: that of controlling the trustee who becomes an agent of, at least, junior creditors. Baird, *The Uneasy Case*, *supra* note 38, at 138. Unlike management, however, the trustee's reputation might not be closely related to the success or failure of the firm, rendering the disciplining effect of reputation not as powerful. See *id.*

A fifth criticism of the Administrative-based Model concerns the fact that this method of bankruptcy creates perverse incentives to managers and claimants. This is because the ownership rights of claimants of an insolvent firm are not defined by an administrative bankruptcy procedure.⁹⁷ This omission prevents an efficient redeployment decision by the residual owner of the firm,⁹⁸ notwithstanding the fact that the identity of the residual owner is highly speculative because the value of the firm is basically unknown.⁹⁹ When redeployment is considered, junior claimants holding “underwater claims” have a strong incentive to delay any possible shut down of the business, even if it is efficient, since liquidation might leave them with nothing.¹⁰⁰ In opposition to those parties are senior creditors—those whose claims are to be paid no matter which course of action is taken—who have an incentive to push for immediate liquidation.¹⁰¹ The Coase Theorem does not solve these problems because a workout cannot be accomplished.¹⁰² Thus, agency problems arise when claimants support a value that destroys reorganization as long as their own share within reorganization exceeds that expected amount if another redeployment path

97. Cornelli & Felli, *supra* note 79, at 476.

98. *Id.*

99. Baird, *The Uneasy Case*, *supra* note 38, at 137-38; Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study* (UCLA School of Law, Law & Econ. Research Paper Series, Paper No. 3-11, 2003) [hereinafter LoPucki, *The Myth*].

100. Aghion et al., *Improving*, *supra* note 48, at 859-60. Consider the following example: senior creditors are owed \$100 and the liquidation value of the firm is \$90. Should things go well, reorganizing the firm would yield a value of \$120. If things go badly, however, the firm will be worth \$40. The average of those disparate outcomes is \$80, which means that the value-maximizing decision is to liquidate, since $\$80 < \90 . However, junior creditors have an incentive to push for reorganization, since if things go well they receive \$20, while in liquidation they receive nothing. Thus, they have nothing to lose from taking a chance on reorganization. A recent study documents this phenomenon.

101. Aghion et al., *Improving*, *supra* note 48, at 858-59. This conclusion holds even for administrative procedures in which control rights are assigned to the secured creditor. See Julian R. Franks & Kjell N. Nyborg, *Control Rights, Debt Structure, and the Loss of Private Benefits: The Case of the U.K. Insolvency Code*, 9 REV. FIN. STUD. 1165, 1198 (1996). Consider the following example to demonstrate the intuition: senior creditors are owed \$100 and the liquidation value of the firm is \$90. Should things go well, reorganizing the firm would yield a value of \$180. But if things go badly, the firm will be worth \$40. The average of those disparate outcomes is \$110, which means that the value-maximizing decision is to reorganize, since $\$110 > \90 . However, senior creditors have an incentive to push for liquidation, since if things go well they receive \$100, whereas if things go poorly they garner only \$40 (the average being \$70, which is less than \$90). A recent study documents the phenomenon.

102. Aghion et al., *Improving*, *supra* note 48, at 860-61. In the cases concerning large firms, there are numerous claimants and negotiations are infected with free-rider and holdout problems. The issue of information asymmetry among various claimants burdens the process further. Indeed, the structured bargaining process mitigates the problems that arise in open bargaining.

is chosen.¹⁰³ Manipulative data released by interested parties, especially shareholders, thwart the process of reaching a decision on proper redeployment of the firm's assets.¹⁰⁴ When the question of the firm's valuation is on the bargaining table, for the sake of deciding who should be included in the distribution of proceeds and whose claims are destined to be wiped out, contradicting estimates are frequently put forward. Recall that senior claimants have an incentive to disingenuously underestimate the firm's value in order to drive junior claimants away from receiving ownership in the firm's assets, while junior claimants have an incentive to overestimate the firm's value, thus securing themselves a slice of the limited value pie.¹⁰⁵ Final valuation is highly dependent on factors such as the relative bargaining power that the parties enjoy.¹⁰⁶ A deadlocked party will sometimes adopt a valuation of the firm and a reorganization plan that are unrealistic.¹⁰⁷ An illustration of the possible gaps in valuation estimates is National Gypsum Company's 1993 reorganization, in which management valued the company at \$182 million, while junior claimants valued the same company at \$1 billion.¹⁰⁸ In this way, adopting inefficient capital structures generates costs in the post-bankruptcy phase, when the firm operates under an incompatible capital structure.¹⁰⁹

A sixth impediment of administrative bankruptcies lies in the fact that insolvency, measured objectively, is not always a prerequisite for the firm to enter the collective procedure.¹¹⁰ As a result, the decision to file for bankruptcy becomes more endogenous rather than exogenous.¹¹¹ Due to the benefits supplied by the court, many companies are using reorganization procedures to serve purposes beyond simple financial restructuring. For example, they engage in controlled liquidation, which is

103. Weiss & Wruck, *supra* note 42, at 58.

104. *Id.*

105. Gilson et al., *supra* note 59, at 45.

106. *Id.* at 65-67.

107. Roe, *supra* note 67, at 539, 541-45. In game theory terms, the parties to the bargaining resemble paratroopers who, having been lost after reaching the ground, finally meet one another at the place most conspicuous on their maps, such as a mountain they previously climbed together, although other, more appropriate rendezvous places exist. The paratroopers choose the inferior meeting spot only because it seemed the most likely place to which everyone will gather. In the firm context, the most likely meeting place for the firm's claimants is something which resembles the old capital structure of the firm; but like the mountain selected by the paratroopers, this familiar turf may not be the proper starting point for a difficult journey.

108. Gilson et al., *supra* note 59, at 45. Other examples appear in appendix. *See id.* at app. 70-73. Note, however, that when examining public records of bankruptcy courts, one can observe only cash flow projections.

109. Roe, *supra* note 67, at 549-58. For example, inferior investment decisions are made when shareholders of the reorganized firm gamble with other people's money. *Id.* at 549.

110. *See, e.g.,* Picker, *supra* note 2, at 519.

111. Bradley & Rosenzweig, *supra* note 83, at 1045.

the sale of the entire firm—or “parcels” of its assets—under the auspices of the stay imposed on debt collection efforts, enabling the quiet, orderly, and time-requiring sale of assets.¹¹² There is also a host of “creative uses” for these proceedings, which is a catchall term for firms’ use of bankruptcy to discharge extremely burdening obligations;¹¹³ such as, enormous mass-tort liability,¹¹⁴ overwhelming judgments,¹¹⁵ environmental liability, pension liability, collective-bargaining contract liability,¹¹⁶ or other long-term obligations. Sometimes bankruptcy is filed strategically in response to another party’s decision that impinges upon the firm.¹¹⁷ In addition, small firms that own a single asset sometimes use bankruptcy to modify the terms of a loan.¹¹⁸ The opportunistic nature of such bankruptcy proceedings is clear. Furthermore, firms whose managers and shareholders behaved so outrageously might earn an opportunity to start fresh due to their questionable dealings—perhaps even with a competitive advantage—a fact that should cause one to question the process’s inherent fairness.

Finally, opponents of the administrative bankruptcy procedure have argued that it inefficiently burdens the process of allowing assets to be used at their highest value.¹¹⁹ The high proportion of reorganized firms that

112. See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 71-72 (2004) (rehearsing an argument Baird raised with Rasmussen in Baird & Rasmussen, *The End*, *supra* note 6); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 605-06 (1993) [hereinafter LoPucki & Whitford, *Patterns*]; Whitford, *supra* note 58, at 1392.

113. Whitford, *supra* note 58, at 1395.

114. A classic example is Johns-Manville’s 1982 declaration of bankruptcy in lieu of catastrophic asbestos liability. See KEVIN J. DELANEY, STRATEGIC BANKRUPTCY 60-81 (1992) (noting the public outrage at Johns-Manville’s bankruptcy declaration due to a perception that this maneuver was an attempt to escape liability to those its operations had injured, a charge denied by the company’s defenders who claim it had no choice given its liability in excess of \$2 billion).

115. A classic example is Texaco. In 1984 Pennzoil won a multibillion dollar judgment against Texaco, who retaliated by filing for Chapter 11. The parties then settled the claim, and Texaco subsequently left bankruptcy. See *id.* at 144-59.

116. A classic example is Continental Airlines. Upon filing for Chapter 11 in 1983, Continental Airlines’ management suspended all flights, locked the company’s union workers out, and resumed operations only after hiring nonunion workers. See DELANEY, *supra* note 114, at 82-125.

117. Chicago Central Pacific Railroads, for example, claimed to be insolvent, with assets exceeding liabilities, because one of its creditors changed the terms of a loan, significantly affecting the railroad’s operations. See Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 750 (1989).

118. See Brian S. Katz, *Single-Asset Real Estate Cases and the Good Faith Requirement: Why Reluctance to Ask Whether a Case Belongs in Bankruptcy May Lead to the Incorrect Result*, 9 BANKR. DEV. J. 77 (1992).

119. For a generalization of the argument, see Michelle J. White, *The Corporate Bankruptcy Decision*, 3 J. ECON. PERSP. 129, 129-30 (1989) [hereinafter M. White, *Corporate Bankruptcy*] (noting how firms are sometimes forced to liquidate when their

suffer from post-bankruptcy poor performance and return to bankruptcy, as well as the significantly low rate of confirmed reorganization plans,¹²⁰ supports this proposition.¹²¹ Administrative-like procedures tend to shield non-viable firms from creditors. Creditors lack the information needed to make quick and correct liquidation decisions.¹²² The mis-deployment error occurs when reorganization is preferred to a more efficient liquidation.¹²³ Recent empirical evidence suggests that the Administrative Model procedures tend to “save” too many non-viable firms.¹²⁴ In this context,

resources would be more valuable in continued operation, while other times the firm continues to operate even though the resources could best be used elsewhere). *See also* Bradley & Rosenzweig, *supra* note 83, at 1048-49 (demonstrating with empirical data that existing bankruptcy law does not give managers enough incentives to allocate corporate resources efficiently).

120. *See* Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 CORNELL L. REV. 1088, 1089 (1992) (reporting the results of a study which found a 10% rate of confirmation); M. White, *Does Chapter 11, supra* note 5, at 1319 (reporting that only one-sixth to one-fourth of small- and medium-size firms in Chapter 11 succeed in adopting a reorganization plan and remain in operation); Rasmussen, *Efficiency, supra* note 69, at 322 (reporting a rehabilitation rate of 20%, after deducting cases ending in plans for liquidation). *But see* LoPucki & Whitford, *Patterns, supra* note 112, at 600-01 (reporting a 96% rate of confirmation in bankruptcies of large, publicly-held companies). Nevertheless, this last finding is eroded by data reporting that within several years one-eighth of these firms undergo either a private restructuring or a repeat reorganization. *See* Hotchkiss, *supra* note 94, at 4; Matthias Kahl, *Economic Distress, Financial Distress, and Dynamic Liquidation*, 57 J. FIN. 135, 135-36 (2002) (discussing the long-term financial impact of debt restructuring).

121. *See, e.g.,* Hotchkiss, *supra* note 94, at 4 (finding that in a sample of 197 public firms emerging from Chapter 11 between the years 1979 and 1988, 40% continued to experience losses and 32% had to undergo another restructuring). *See also* James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 963 (1994) (reporting that only 21% of Chapter 11 “megabankruptcies” in the LoPucki and Whitford study have resulted in true rehabilitation). *But see* Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161, 189-90 (1997) (arguing that a firm may rationally choose to remain highly leveraged after reorganizing. For example, in order to increase monitoring of managers, repeat reorganizations should not be taken as evidence that Chapter 11 produces inefficient capital structure).

122. Kahl, *supra* note 120.

123. Many studies discuss this point. *See* Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 438 (1978); M. White, *Corporate Bankruptcy, supra* note 119, at 143-44, 147-48; Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1213-14 (1991); Robert Mooradian, *The Effect of Bankruptcy Protection on Investment: Chapter 11 as a Screening Device*, 49 J. FIN. 1403 (1994).

124. *See* Timothy C.G. Fisher & Jocelyn Martel, *Empirical Estimates of Filtering Failure in Court-Supervised Reorganization*, 1 J. EMPIRICAL LEGAL STUD. 143 (2004) (producing evidence from Canada to show that Type I errors are four times more likely to occur than Type II errors). In other words, creditors and judges during an administrative reorganization are four times more likely to accept proposals from nonviable firms than to reject proposals from viable firms.

some scholars point to studies that contradict the "high transaction costs market hypothesis" offered by some advocates of the Administrative Model.¹²⁵ Indeed, one can find much empirical support for the claim that bankruptcy reorganization procedures, such as the American Chapter 11, are inefficient and costly. They impose higher transaction costs than the market,¹²⁶ and only partially accomplish the rehabilitation target.¹²⁷

One famous example scholars cite is the case of Eastern Airlines, the American airline that filed for bankruptcy in 1989.¹²⁸ Upon entering Chapter 11, Eastern Airlines' existence could easily be considered economically unjustified. Besides having a bad reputation among passengers, the company had a long tradition of investing in the wrong projects, including propeller aircrafts. Although operating on the very competitive East Coast in an already saturated industry, the company did not have a unique market niche. In the years preceding its Chapter 11, the company sold important assets, such as its right to operate between Washington, D.C. and New York. Labor costs were high, since the company was paying above-market wages to its employees, a fact that did not prevent frequent management-employee conflicts. Despite having the opportunity to liquidate the company in return for a reasonable dividend to creditors, Eastern Airlines was kept alive under Chapter 11 for another twenty-two months by a judge about whom *Forbes* magazine wrote an article titled "A Bankrupt's Best Friend."¹²⁹ This bankruptcy judge announced his willingness to try to revive the airline for the sake of its customers and employees.¹³⁰ The Judge allowed Eastern Airlines' management to conduct "asset stripping" maneuvers, to use the company's

125. Bowers, *supra* note 121, at 960-61.

126. *Id.* at 961 (arguing that "Chapter 11 apparently discourages potential competition among bidding firms and thus awards gains to bidders that exceed the normal competitive return bidders earn in unobstructed markets. While in those markets, the target company's shareholders capture the gains that result from the bidding, in Chapter 11, the bankrupt firm's owners must share more of the gains with the bidder. In other words, the Chapter 11 process itself imposes higher transaction costs than the unobstructed market imposes").

127. For a useful analysis on transactional costs and Chapter 11, see LoPucki & Whitford, *Patterns*, *supra* note 112.

128. The following description is based on Weiss & Wruck, *supra* note 42; Baird, *Revisiting*, *supra* note 48, at 633.

129. Weiss & Wruck, *supra* note 42, at 62 (citing Seth Lubove, *A Bankrupt's Friend*, *FORBES*, Apr. 1, 1991, at 99, 102 (describing the judge as one who "believes that when Congress . . . reformed Chapter 11, it wanted to give high priority to keeping bankrupt businesses going rather than having them liquidated for the benefit of creditors . . . [The Judge's] pro-debtor reputation is so widespread that companies which want to stiff their creditors are known to 'forum shop' to get their cases before him.")).

130. *Id.* at 56.

assets¹³¹ to finance continued operations, for a considerable length of time. The gloomy result was a further loss of about \$1.3 billion and a decline in value of about \$2 billion, the equivalent of half of Eastern Airlines' original value.¹³² Facing such a poor outcome, Eastern Airlines terminated its operations in 1991.

Many deficiencies of administrative bankruptcy are exacerbated by general problems that reign in some jurisdictions, such as inefficient judicial systems, vague laws, poor registration of property rights and deficient accounting standards that make it difficult to sort out claims, among others.¹³³

3. The Case for Administrative Decision-Making

Scholars have argued in favor of current Administrative-based Models of bankruptcy and reorganization across the board. One argument favoring a Chapter 11 model of bankruptcy procedure focuses on this model's ability to increase the survival rate of firms, especially firms with ongoing concern value.¹³⁴ A court-supervised procedure can better utilize firm-specific assets, since assets are kept within their intended industry rather than being sold for scraps.¹³⁵ The procedure rescues firms filing under its terms and also firms not in a formal bankruptcy procedure but slightly financially distressed.¹³⁶ When markets suffer from imperfections or temporary downturns¹³⁷ that cause market sale of the firm's assets to be an

131. During attempts to reorganize, Eastern Airlines' management sold routes, gates, planes, engines, and spare parts, for a total sum of \$1.8 billion. Of that amount, \$928.2 million was used to finance the company's ongoing operations. *See id.* at 65.

132. *Id.* at 56 (but see the exact explanation for this result). Note however, that the Eastern Airlines case is not representative of a Chapter 11 proceeding for large public companies. *See* Whitford, *supra* note 58, at 1386.

133. *See* Hart et al., *supra* note 48, at 463.

134. M. White, *Costs*, *supra* note 17, at 494. *But see* S. Abraham Ravid & Stefan Sundgren, *The Comparative Efficiency of Small-Firms Bankruptcies: A Study of the US and Finnish Bankruptcy Codes*, 27 FIN. MGMT. 28, 38 (1998) (concluding that an auction-only regime did not lead to more liquidations than a regime with a Chapter 11 alternative).

135. Bradley & Rosenzweig, *supra* note 83, at 1043-44. Often a firm's financial distress is accompanied by an industry-wide downturn. Industry insiders, who can better evaluate and use the assets of the firm, are thus more prone to be cash constrained. The inefficient result occurs when firms left un-reorganized are sold to outsiders who put the assets to lower-valued uses. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343, 1355-56 (1992).

136. Bufford, *supra* note 48, at 836-38 (describing Chapter 11 as a safety net for the national economy based on a review of events surrounding the 1933 depression).

137. Nicholas L. Georgakopoulos, *Bankruptcy Law for Productivity*, 37 WAKE FOREST L. REV. 51, 78 (2002).

unwarranted alternative, the opportunity to reorganize the firm becomes more important.¹³⁸

Some have argued that Chapter 11 was only able to endure because it was efficient.¹³⁹ Moreover, the particular structure of Chapter 11 has evolved over time for specific reasons.¹⁴⁰ This idea is supported by the observation that Chapter 11 enables controlled liquidation of a firm's assets when its results are superior to any other form of liquidation, such as a straightforward auction.¹⁴¹ Creditors receive higher payoffs when reorganization is allowed over liquidation.¹⁴² There is empirical evidence to support this argument, particularly in the case of small- and medium-sized firms.¹⁴³ Indeed, similar considerations drove several countries previously without reorganization alternatives to amend their bankruptcy codes.¹⁴⁴ It has thus been argued that upon acceptance of the assumption of imperfect markets, an administrative procedure is a better solution.¹⁴⁵ Even when used by firms "opportunisticly" to discharge a specific kind of obligation, the Administrative Model is able, at least in some cases, to reach socially desirable results.¹⁴⁶

For example, William Whitford reviewed empirical evidence to support the continued existence of Chapter 11.¹⁴⁷ He concluded that the direct costs in Chapter 11 cases, i.e., fees paid to professionals accompanying the procedure, were high for bankruptcies of small firms,¹⁴⁸

138. Hart et al., *supra* note 48, at 463; Bufford, *supra* note 48, at 846-47.

139. Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 413-14 (1990) ("Enduring legal institutions endure either because they are efficient or because they redistribute wealth to concentrated, politically effective interest groups."). Transfer of wealth, Easterbrook argues, is an implausible explanation for the current bankruptcy regime, so efficiency is the only possible explanation. *Id.* at 414-15. *See also* Tene, *supra* note 14, at 291-92.

140. *See* Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 808 (1993).

141. Whitford, *supra* note 58, at 1394.

142. *See, e.g.*, Ravid & Sundgren, *supra* note 134, at 38. A recent study indicates that creditor recovery rates are much higher in Chapter 11 cases than in Chapter 7 cases.

143. Stefan Sundgren, *Does a Reorganization Law Improve the Efficiency of the Insolvency Law? The Finnish Experience*, 6 EUR. J. L. & ECON. 177, 178 (1998) (presenting evidence that creditors on average receive a significantly higher payoff in reorganizations than in liquidations—between 10.7% and 15%).

144. *See* Ravid and Sundgren, *supra* note 134, at 29-30. Such countries include Finland, Sweden, France, Germany, Netherlands, and Britain.

145. Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 HOFSTRA L. REV. 117, 142-48 (1991); Whitford, *supra* note 58, at 1379-80, 1395.

146. *See* Whitford, *supra* note 58, at 1395-98 (arguing that "creative uses" of bankruptcy at least supplies a quick solution).

147. Whitford, *supra* note 58.

148. A study conducted on small firms in Finland indicated a different result, finding that the direct costs of auctions were no less than the direct costs of reorganizations. *See* Ravid & Sundgren, *supra* note 134, at 38. *See also* Sundgren, *supra* note 143, at 179.

but relatively low for bankruptcies of large public firms.¹⁴⁹ Similarly, he concluded that there were deviations from the absolute priority rule in Chapter 11 cases, but they were relatively modest at about 10% of the entire distributed value.¹⁵⁰ The classic example for a Chapter 11 case, if one exists at all,¹⁵¹ is not the travesty of Eastern Airlines, Whitford argued; but rather a case in which a company with cash liquidity trouble and some bad business decisions takes advantage of the stay imposed on its unsecured creditors, maintains its business during the procedure, and completes restructuring efforts that began before filing for bankruptcy.¹⁵²

Other scholars have suggested that certain adjustments should be made to the existing Administrative Model, such as providing a non-waivable application of the absolute priority rule—for those strictly adhering to the absolute priority rule—and a mandatory termination of the “exclusivity period” granted to incumbent management.¹⁵³ These adjustments are intended to overcome the faults of the model, mainly strategic behavior by players.¹⁵⁴ Adoption of regimes implemented in

149. See Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (setting the direct costs of a sample of large firms at an average of 3% of asset value); Whitford, *supra* note 58, at 1381. Whitford argued that one must also take into account both the direct costs wasted on alternative bankruptcy procedures, as well as the fact that if a formal bankruptcy is not initiated, indirect costs, such as costs of monitoring by creditors, would replace direct costs, e.g., monitoring by professionals. See *id.* at 1382. See also Easterbrook, *supra* note 139, at 415 (comparing costs of administrative bankruptcy to the costs of going public with a corporation).

150. Whitford, *supra* note 58, at 1382-83, n. 13.

151. Several scholars have argued that one needs to be very careful in the bankruptcy context in choosing “representative” cases to illustrate arguments. Indeed, famous bankruptcy cases of large publicly-held companies are often not reflective of the kind of cases that occupy the courts’ dockets which usually involve closely-held firms. See Rasmussen, *Efficiency*, *supra* note 69, at 321-22.

152. See Whitford, *supra* note 58, at 1386-87 (describing the case of AM International, a manufacturer and distributor of graphics equipment). The company filed for bankruptcy in 1982, with \$500 million in assets. Its financial difficulties resulted from an inexpedient expansion, which increased the company’s debts. After replacing the management, the company began to unload assets in order to repay debts, a process interrupted by unsecured bank creditors’ threats to repossess unless collateral was exchanged. Once in bankruptcy, the company negotiated a reorganization plan, under which it borrowed money against its assets in order to distribute cash to creditors, and shareholders retained 36% of the shares in the reorganizing company. The plan was confirmed 28 months after the company had filed for bankruptcy. Creditors were later able to trade the shares, which sold well in the stock market, and receive full payment. The company returned to Chapter 11 in 1993, with a repackaged plan, but was again able to rise as a viable entity.

153. Jackson, *supra* note 76, at 663.

154. See *id.* See also Altman, *supra* note 45, at 4 (recommending a shorter exclusivity period); J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 306 (1991) (proposing ideas on how to improve the bargaining and valuation process); LoPucki & Whitford, *Venue Choice*, *supra* note 88, at 48 (suggesting a reduction of judicial discretion

specific countries, such as in Canada, has been suggested.¹⁵⁵ Improving decisions made by bankruptcy judges, and their role in the proceedings in general, has also been advocated as a change that current legal regimes should adopt.¹⁵⁶ Implementation of special procedures for small, closely-held firms¹⁵⁷ as well as combining an Administrative Model with market-based procedures, such as an auction, has also been suggested.¹⁵⁸ Another proposal was to automatically wipe out underwater claims, especially those of shareholders.¹⁵⁹ Appointing impartial examiners to assist in judicial decision-making was also offered.¹⁶⁰

It has also been contended that the idea of reforming bankruptcy laws might be a mixed blessing. The economy's debt structure, whether market-

in extending periods of exclusivity, and limiting such periods to one year); Tabb, *supra* note 140, at 824 (listing all relevant reform proposals).

155. See George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. & ECON. 101, 104 (1996) (comparing the interplay of liquidation and reorganization bankruptcy proceedings in Canada with those in the United States).

156. See Baird & Morrison, *supra* note 26, at 367-68. Nevertheless, arguments supporting the current role of judges have also been made, such as requiring bankruptcy judges specialize in a narrow field, thus becoming "experts." See Lynn M. LoPucki, *Can the Market Evaluate Legal Regimes? A Response to Professors Rasmussen, Thomas, and Skeel*, 54 VAND. L. REV. 331, 352 (2001) ("Congress has anointed bankruptcy judges as the independent experts charged with evaluating plan feasibility.").

157. See Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991) (advocating a selective stay regime, under which a large financing creditor, a bank for example, better informed than anyone else of the firm's prospects as an ongoing concern, would be the one to value the firm and negotiate, when necessary, a bargain with the firm's owners). See David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 510-17 (1993) (advocating certain changes in current Chapter 11 provisions as far as closely-held firms are concerned). See also Karen M. Gebbia-Pinetti, *Small Business Reorganization and the SABRE Proposals*, 7 FORDHAM J. CORP. & FIN. L. 253 (2001) (suggesting, among other reforms, a federal workout procedure for small firms, which can be initiated only when at least a few unaffiliated creditors join the firm's petition for the protection of the court). In 1994 the United States Bankruptcy Code was amended to include a fast-track bankruptcy alternative for small firms. See 11 U.S.C. § 1121(e) (2000 & Supp. V 2005).

158. See Robert G. Hansen & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance*, 18 INT'L REV. L. & ECON. 159, 161-62 (1998) (advocating the use of auctions in certain circumstances and traditional Chapter 11 proceedings in others).

159. This reform was named a "preemptive cram down." See Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991). Upon commencement of a bankruptcy case, a motion for eliminating the interests of equity holders would be brought before the bankruptcy court. An order extinguishing such interests would be issued after a hearing. *Id.* at 636-42.

160. See Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 ARIZ. L. REV. 89, 135-38 (1992) (advocating the use of an examiner who would be an independent fact-finder).

based or bank-based,¹⁶¹ is important in determining the overall efficiency of a bankruptcy law.¹⁶² Thus, it has been contended, for example, that information acquisition technologies and the economy's primary method of financing, whether bank-oriented or market-oriented, determine the need for either a creditor-initiated bankruptcy procedure or a debtor-initiated bankruptcy procedure.¹⁶³ Developed countries with bank-based systems, like Germany, should have a creditor-initiated bankruptcy system, while countries with market-based financing systems, like the United States, or with underdeveloped economies should have a debtor-initiated chapter and a creditor-initiated chapter in its bankruptcy law.¹⁶⁴

The lesson to be learned is that the need for bankruptcy reform is economy-dependent and reforms may not fit every jurisdiction. On the other hand, because financial systems are likely to adapt themselves to a given bankruptcy system,¹⁶⁵ the company itself can change in the face of a relatively inefficient bankruptcy law by amending its sources of credit, for example more bank loans, to facilitate out-of-court restructuring in the case of insolvency, such as negotiating with fewer creditors.¹⁶⁶ However, in countries with market-based credit systems, enhancing the efficiency of formal bankruptcy laws seems to be a good idea overall.¹⁶⁷ These trends explain the wave of reform proposals in the literature, most of which are market-based.

161. In a market-based economy, most of the borrowing by firms is done through the capital market. Creditors obtain information about the firm independently, from the market, and do not depend on the firm or its managers to supply it. In a bank-based economy, most of the borrowing is done from banks and financial institutions. See Franklin Allen & Douglas Gale, *A Welfare Comparison of Intermediaries and Financial Markets in Germany and the U.S.*, 39 EUR. ECON. REV. 179 (1995).

162. See Elazar Berkovitch & Ronen Israel, *Optimal Bankruptcy Laws Across Different Economic Systems*, 12 REV. FIN. STUD. 347 (1999) [hereinafter Berkovitch & Israel, *Optimal Bankruptcy*]. In a bank-based economy, but not in a market-based economy, managers can guess rather successfully what creditors will know about the firm; when managers understand that creditors do not know that the firm should be liquidated, managers can continue to run an inefficient firm. In an under-developed economy, creditors have little or no information on the firm since financial institutions and markets are not yet developed.

163. See *id.* at 349. In a creditor-initiated regime, a creditor alone can file for bankruptcy liquidation, and once he does, management loses its control over the firm. In a debtor-initiated regime, the debtor can file for bankruptcy and retain control of the firm.

164. *Id.*

165. See Hege, *supra* note 47, at 261. The intuitive explanation is that one should always bare in mind the possibility for an out-of-court restructuring (a workout). But, as already mentioned, workouts are unlikely to succeed when firms borrow from credit markets rather than from banks because of a holdout problem.

166. *Id.* at 236. Bankruptcy reform is caught in a "trap" in light of the paradox being created when making things worse (less efficient bankruptcy laws) actually might make things better (more successful workouts).

167. *Id.*

B. *Market-Based Solutions: The Quest for the Residual Owner*

Against the background of immense criticism over court-supervised bankruptcy, proposals were put forward to substitute the Administrative Model with a market-based decision-making mechanism. The driving force of many reform proposals has been the proposals' contended ability to pinpoint the firm's residual owner; be that the "true" residual owner of a firm, who may be unknown,¹⁶⁸ or a "newly created" residual owner via a sale of the assets, liability free, to a third-party buyer. Once located, the residual owner would be chosen, as a matter of course, as the relevant decision-maker to make the redeployment decision. Indeed, law and economics theory assumes that the residual owner's incentives are perfectly aligned with those of the firm because he or she stands to reap the firm's marginal profit or suffer its marginal loss. Redeployment led by the residual owner is considered optimal, simply because the residual owner makes the redeployment decision while enjoying the benefits of making good decisions and incurring the costs of making bad ones.¹⁶⁹ The problem with the Residual Owner Model is how to identify who in fact is the residual owner of any given firm in any given situation at any given time.¹⁷⁰

1. The Auction Solution

Douglas Baird,¹⁷¹ Thomas Jackson,¹⁷² William Meckling,¹⁷³ and Michael Jensen¹⁷⁴ have separately offered to adopt a mandatory auction

168. See Baird & Jackson, *supra* note 14, at 108-09 (discussing the need to create mechanisms that allow disparate owners to act as one, and emphasizing the advantages of ensuring that decision-makers were residual owners who bore the costs and benefits of any decision they made).

169. Of course, this is true only at first approximation. Any debt in a firm's capital structure creates an overinvestment incentive. However, creditors can protect their interest via price and contract terms.

170. The question of whether a residual owner in fact exists in financially distressed firms is currently under debate. Compare LoPucki, *The Myth*, *supra* note 99 (arguing that the residual owner approach to bankruptcy proceeding still exists), with Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 694-97 (2003) (discussing the lack of a residual owner in the financially distressed firm WebVan).

171. See Baird, *The Uneasy Case*, *supra* note 38.

172. See JACKSON, *supra* note 65, at 218-24.

173. See William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41(4) LAW & CONTEMP. PROBS. 13, 38 (1977) (arguing that "[a]s a result of intensive research . . . we now know a great deal about how the value of firms is determined in financial markets. Most of us would have little faith that estimates derived by the SEC staff would be superior to those that markets would generate. Why not use the market to determine the value of the firm? Indeed, why not simply hold auctions for firms which go into bankruptcy, or issue claims on firms in bankruptcy and use their value to fix the value of the firm?").

solution,¹⁷⁵ or, in other words, an only-liquidation bankruptcy regime. According to this proposed reform, the bankruptcy court, perhaps with the aid of a trustee, would auction the firm's assets, accepting either bids for only specific assets or for the entire going concern, and sell those assets stripped of pre-bankruptcy liabilities to a third-party buyer at a price that would reflect the "true" market value of the firm.¹⁷⁶ The "pot of cash" generated from the sale would be distributed to the pre-bankruptcy claimants according to the absolute priority rule. Even if the assets are sold only as a single complex firm as a whole, the buyer can dismantle the assets.

Baird has argued that an auction is cheaper.¹⁷⁷ He reasons that since the auction can be accomplished quickly, it reduces procedure costs—the direct and indirect costs of bankruptcy—induces parties to reveal information,¹⁷⁸ and keeps the task of redeployment separate from that of distribution.¹⁷⁹ Assets can thus be transferred immediately to their highest-valued use,¹⁸⁰ and distributional impulses such as deviations from the absolute priority rule can be prevented.¹⁸¹ The change of ownership of the firm, which entrusts the firm with a new and thus certain residual owner,¹⁸²

174. See Jensen, *supra* note 77, at 31-32.

175. The requirement for a mandatory auction derives from several problems, such as an adverse selection problem that might burden the process of selling good firms to third-party buyers. See Baird, *Revisiting*, *supra* note 48, at 646-47.

176. See Baird, *The Uneasy Case*, *supra* note 38, at 139; Baird, *Revisiting*, *supra* note 48; Ryland, *supra* note 84, at 2271 ("With the recent development of a deeper—and therefore more efficient—market for higher risk securities . . . and the growth in 'vulture funds' (investment managers specializing in securities of troubled firms), it makes sense to reconsider the market auction mechanism in bankruptcy reorganizations.") (footnotes omitted). Baird's auction solution is offered mainly for large, publicly-held companies.

177. Investment bankers are quite proficient in auctioning even large firms. An offering of stocks can cost between 4% of total proceeds in underwriter compensation and other expenses, and 15%, if small offerings less than \$2 million are the issue. See Clifford W. Smith, Jr., *Alternative Methods for Raising Capital: Rights Versus Underwritten Offerings*, 5 J. FIN. ECON. 273 (1977) (examining why firms choose underwritten offerings rather than rights offerings when finance theory suggests rights offerings should be used to raise equity capital).

178. See Baird & Morrison, *supra* note 26, at 368-70. See also Ryland, *supra* note 84, at 2271-72 (describing an auction duty imposed on incumbent managers as a method to reduce agency costs created under a Chapter 11 governance regime).

179. See Baird, *Revisiting*, *supra* note 48, at 634, 638-39.

180. See Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. FIN. INTERMEDIATION 240, 244, 260-61 (1998) [hereinafter Hotchkiss & Mooradian, *Acquisitions*]. The post-bankruptcy performance of firms acquired in a bankruptcy procedure was found to be better than that of independently reorganized firms due to reduction in operating expenses and employment costs. But the authors noted that the effects of imposing a mandatory auction, rather than a voluntary one, are yet unclear.

181. See Jackson, *supra* note 76, at 658.

182. See Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1202.

who may also change strategy and management, can generate significant value.¹⁸³

Auctioning the firm's assets can remove the bias towards reorganization often observed in administrative bankruptcy procedures.¹⁸⁴ Nevertheless, an auction can still preserve firm-specific skills or ongoing concern value since the assets can be sold as a unit. For example, if employing managers of a closely-held firm is crucial for the firm's survival as an ongoing concern, or can create the added value which is not available in piecemeal sale of the assets, the buyer of the firm in the auction can bargain with the managers and obtain their services even in exchange for shares in the firm, if management participation is for some reason conditioned upon receiving equity.¹⁸⁵ When publicly-held companies are the subject matter, it is reasonable to assume that owners of the company seldom place a special value over the market value on the assets, as do owners of closely-held companies; those that do place such a value can bid at the auction.¹⁸⁶

A well-known example of a documented, successful auction was the case of Financial News Network (FNN), which entered Chapter 11 in 1991.¹⁸⁷ FNN's managers signed an agreement to sell the company for \$90 million; but subsequently, the bankruptcy court auctioned the firm for \$146 million,¹⁸⁸ a fact that also enabled later conflicts between creditors to be resolved without impeding the redeployment of the assets.¹⁸⁹ Similarly, the Baltimore Orioles baseball team was auctioned and sold in 1993, within a period of only three months, for \$173 million, instead of \$145 million as its owners intended to do just prior to filing for bankruptcy.¹⁹⁰

Criticism over the auction solution suggests that despite the fact that auctioning a firm may sometimes prove to be efficient, it may also be too costly in other occasions—for example, when auctioning large firms.¹⁹¹

183. See Hansen & Thomas, *supra* note 158, at 164 (comparing auctions to hostile takeovers, which generate a premium for shareholders of 30% above market price). Firms sold in a bankruptcy auction resemble firms being taken over because of existing potential to improve the firm's performance.

184. See M. White, *Costs*, *supra* note 17, at 495; Hansen & Thomas, *supra* note 158, at 164-65 (arguing that auctioning bankrupt firms' assets increases efficiency).

185. Baird, *The Uneasy Case*, *supra* note 38, at 139-40 (arguing that the new owners of the firm are in a bargaining position with management).

186. See *id.* at 141-42 (discussing potential efficiencies of a forced sale of assets to the original owners).

187. Hansen & Thomas, *supra* note 158, at 160.

188. *Id.*

189. Baird, *Revisiting*, *supra* note 48, at 634.

190. Hansen & Thomas, *supra* note 158, at 160.

191. See Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 320 (1993) (discussing the direct and indirect costs of auctions). See also LoPucki & Whitford, *Corporate Governance*, *supra* note 83, at 765

A second problem is that of “fire sales,” which result in loss of value.¹⁹² Sometimes distressed firms’ assets are better sold in a controlled manner, over a period of time, and in parcels of assets instead of a single unit.¹⁹³ Indeed, evidence indicates that even in a competitive auction, prices paid for bankrupt firms are at substantial discounts,¹⁹⁴ which result in considerably lower payoffs for creditors.¹⁹⁵ The market would like to observe the firm’s post-filing performance before valuing the firm properly.¹⁹⁶

Another related problem arises from lack of suitable bidders in the auction. This is particularly problematic, as financial distress often strikes entire industries in a manner that could prevent those who value the firm the most from participating in the auction.¹⁹⁷ Still, bidders might be competitors of the auctioned firm, interested only in reducing competition in the market, or those who are interested in buying the assets in order to sell them later, when economic conditions improve.¹⁹⁸ The costs of evaluating the firm’s assets, including the costs of acquiring sufficient information for that purpose, might be high enough to deter many bidders.¹⁹⁹ Informational asymmetry may impede acquisitions of distressed

(arguing that auctioning a large firm can be more expensive than reorganizing under Chapter 11); Adams, *supra* note 145, at 142-48 (arguing for less expensive alternatives to liquidation); Easterbrook, *supra* note 139, at 415 (explaining how auctions of firms may end up costing more than IPOs). *But see* Hansen & Thomas, *supra* note 158, at 166-68 (arguing that Easterbrook’s calculation of IPO costs is too low).

192. See Branch, *supra* note 51, at 60 (indicating that “[B]ankrupt firms are damaged merchandise. Sale of damaged goods under pressure rarely results in the best price.”).

193. See Whitford, *supra* note 58, at 1393 (discussing potential benefits of allowing buyers to repackage the firm’s assets); LoPucki & Whitford, *Corporate Governance*, *supra* note 83, at 758-65 (discussing scarcity of potential bidders). The more complex the firm’s capital structure, the less likely the firm is to be acquired. See Hotchkiss & Mooradian, *Acquisitions*, *supra* note 180, at 260.

194. Hotchkiss & Mooradian, *Acquisitions*, *supra* note 180, at 260 (arguing that complex negotiations in bankruptcy make firms less desirable for acquisition).

195. See Ravid & Sundgren, *supra* note 134, at 38 (comparing payoffs to creditors in auctions and in reorganizations).

196. Branch, *supra* note 51, at 60 (arguing that quick sale of assets from bankrupt company will result in market discount).

197. See Baird, *Revisiting*, *supra* note 48, at 648 (discussing that industry distress may prevent firms from bidding). Evidence suggests that buyers of assets from firms in bankruptcy tend to be of the same industry. See LoPucki & Whitford, *Corporate Governance*, *supra* note 83, at 764 (generalizing examples of bidders existing only from same line of business); Shleifer & Vishny, *supra* note 135, at 1355-56 (arguing that money outside the given industry is insufficient to remove illiquidity).

198. See Shleifer & Vishny, *supra* note 135, at 1356. Assets might not spend time in the hands of those who value them the most and can make the best out of them.

199. See Adler, *supra* note 191, at 320-21 (discussing the indirect costs of investigating prospective acquisition targets); Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 527-28 (1992) [hereinafter Aghion et al., *Economics*] (discussing transaction costs of obtaining investment); LoPucki &

firms when out-of-industry buyers are uninformed not only about the firm value, but also about the best use of the firm's assets.²⁰⁰ Cash-constrained bidders are also withheld from participating in the auction even though they might value the firm the highest and know best how to utilize its assets. Bidders might also be unfamiliar with the firm, a fact that might require a period of adjustment, and necessitate a process very similar to that conducted under a formal lengthy bankruptcy procedure.²⁰¹ The firm's atypical activity on the eve of auction aggravates this problem.²⁰²

A third problem associated with auctions concerns pre-bankruptcy incentives. For example, management of the firm might be driven to either delay the process of bankruptcy and reorganization, or misuse the firm's assets on the eve of bankruptcy, thus creating incentives to deploy the assets improperly.²⁰³ In a mandatory auction regime, managers also have a strong incentive to invest in projects—not necessarily good ones—as long as these projects give them private information, in order to assure that they are retained after the auction.²⁰⁴

Fourth, the auction solution does not solve the problem of needing a judge-made valuation. Even when distributing the proceeds of an auction according to the absolute priority rule, one still needs to value the secured creditor's collateral, apart from the overall market value of the firm, in order to determine that creditor's priority over lower-ranking creditors.²⁰⁵ One also needs to value the claims.²⁰⁶

Whitford, *Corporate Governance*, *supra* note 83, at 761-63 (discussing need for delay and costs of sale); Skeel, *supra* note 157, at 478 n.42 (arguing that potential losses from unsuccessful bidding may discourage bidders).

200. A "lemons problem" might be created when "good" firms will choose to reorganize rather than attempt a sale, in a market pooled with "bad" firms offered at low prices. See Hotchkiss & Mooradian, *Acquisitions*, *supra* note 180, at 242-43 (describing Gertner and Picker's argument and finding empirical support for this argument).

201. This argument was similarly put forward by Robert Gertner and Randal Picker. See Baird, *Revisiting*, *supra* note 48, at 650-51 (arguing that Chapter 11 can give time to learn more about the firm's assets).

202. See Skeel, *supra* note 157, at 479 (arguing that management is more opportunistic immediately before bankruptcy).

203. See LoPucki & Whitford, *Corporate Governance*, *supra* note 83, at 756-58 (discussing management incentive to prolong bankruptcy); Karin S. Thorburn, *Bankruptcy Auctions: Costs, Debt Recovery, and Firm Survival*, 58 J. FIN. ECON. 337, 339 (2000) (discussing conflicts between owner-managers and debt holders); M. White, *Corporate Bankruptcy*, *supra* note 119, at 148-49 (discussing management incentives to waste assets and take risks on eve of bankruptcy).

204. Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1203.

205. See Adler, *supra* note 191, at 321 (discussing difficulty in bidding against informed bidders); Lucian Arye Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 HARV. L. REV. 2388, 2406-07 (2001) [hereinafter Bebchuk & Fried, *New Approach*] (arguing that in auctions valuation will still occur to determine the value of assets with security interest); Hansen & Thomas, *supra* note 158, at 172-74 (discussing secured interest in property that loses value during bankruptcy); Jackson, *supra*

Fifth, the auction mechanism in the bankruptcy context might also be a source of inefficiencies. Bidders are likely to fear the “winner’s curse” that would have them pay too much.²⁰⁷ Unless a specific auction method is mandated, conflicts might arise between claimants.²⁰⁸ Studies have shown that the more uncertainty that exists regarding the value of the firm’s assets, the lower the proceeds of the sale.²⁰⁹ More importantly, evidence exists showing inefficient allocation of resources emanating from auctions conducted when one bidder also has an initial stake in the auctioned assets.²¹⁰ The case of managers forming a coalition with creditors to bid in bankruptcy auctions is quite common in this context.²¹¹ Such a coalition, acting—in Chapter 11 cases when incumbent management is retained as a debtor in possession—as both the seller and bidder, has an incentive to overbid above the coalition’s own evaluation of the firm in order to induce a higher counteroffer.²¹² Such a counteroffer would benefit the bidding coalition, generating more value for their pre-bankruptcy claims, but it can also deter the other bidders from participating in the auction.²¹³ Although, it was argued that allowing management to choose a voluntary auction rather than mandate such an auction might mitigate the problem.²¹⁴

note 76, at 666-67 (discussing the difficulty in valuing patents and other intellectual property outside the firm as a whole). Indeed, the secured creditor’s priority over junior creditors depends on the value of his collateral. When distributing even a “pot of cash,” the bankruptcy court needs to know who gets what.

206. Easterbrook, *supra* note 139, at 416 (contrasting judicial and market valuations). For example, the court needs to value contingent claims held by injured persons or the costs of cleaning up toxic waste.

207. Skeel, *supra* note 157, at 478 n.43.

208. See Sugato Bhattacharyya & Rajdeep Singh, *The Resolution of Bankruptcy By Auction: Allocating the Residual Right of Design*, 54 J. FIN. ECON. 269, 271-72 (1999) (discussing conflicting sales preferences between senior and junior creditors). For example, senior claimants have a strong preference for the use of a first-price sealed-bid auction over an ascending-bid auction, but junior claimants have the opposite preference.

209. Hansen & Thomas, *supra* note 158, at 168-70.

210. Edith S. Hotchkiss and Robert M. Mooradian, *Auctions in Bankruptcy*, 9 J. CORP. FIN. 555, 556-57 (2003) [hereinafter Hotchkiss & Mooradian, *Auctions*].

211. *Id.* at 557 n.4.

212. *Id.*

213. *Id.* The authors concluded that the overbidding problem depends on the structure of the firm’s claims.

214. *Id.* at 558. In a bankruptcy system that permits auctions rather than mandates them, management’s choice to seek a buyer to bid in an auction conveys information to potential bidders. To be sure, such a choice sends a message that management thinks that the valuation of the firm is relatively low (and will bid low). The probability that a second bidder will enter the auction increases. The likelihood of a competitive auction increases also.

Current administrative bankruptcy regimes allow an auction of the firm, even as a whole, to take place.²¹⁵ Evidence exists of efficient auctions conducted, for example, in Chapter 11 proceedings.²¹⁶ Sales of firms in an administrative bankruptcy procedure seem to occur with increasing frequency in recent years.²¹⁷ But often, courts do not resort to auctioning the firm.²¹⁸ Private workouts do not include an auction,²¹⁹ and neither corporate charters nor debt covenants integrate an auction alternative as an ex ante contractual solution to the firm's insolvency. Perhaps the reason is that an auction is not always the best solution.²²⁰

An interesting line of inquiry relates to countries entertaining—at least effectively—an auction-only bankruptcy regime such as the United States (Chapter 7), Sweden (before 1996), Finland (before 1993), Germany (before 1999), Belgium, Switzerland, and the Netherlands. Evidence found in these countries is inconclusive regarding the superiority of an auction-only regime.²²¹ On one hand, a study conducted in closely-held firms in Sweden found that real life auctions actually resemble reorganization, since quick sales of assets are avoided by a restructuring of the firm's capital. This restructuring occurs when the previous owner of the firm bids in the auction and negotiates a deal with a creditor bank that finances the bid.²²² Other problems arising from auction-only regimes include conflicts of interest among claimants, which lead to inefficient continuation and deviations from the absolute priority rule.²²³ Another recent study revealed that an auction might not be as cheap or as time saving as one would think.²²⁴

On the other hand, evidence for the superiority of auctions was found in another study indicating a 75% rate of going-concern survival in a sample of closely-held firms.²²⁵ This rate resembles the rate of survival

215. Chapter 7 of the United States Bankruptcy Code is basically an auction solution. See Whitford, *supra* note 58, at 1402 (indicating that appointing a trustee in Chapter 11 should also trigger an auction solution).

216. Hotchkiss & Mooradian, *Auctions*, *supra* note 210, at 556.

217. *Id.*

218. Hansen & Thomas, *supra* note 158, at 183 (arguing that courts are afraid of a failure of the auction, and are unaware of the relative ease with which auctions could be successfully accomplished).

219. Easterbrook, *supra* note 139, at 413.

220. See generally Hansen & Thomas, *supra* note 158 (concluding that auction does not always dominate an Administrative Model of bankruptcy).

221. See Ravid & Sundgren, *supra* note 134, at 38.

222. See Per Strömberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 J. FIN. 2641, 2644, 2683 (2000).

223. *Id.* at 2683.

224. See Ning Zhu, *Is Cash Auction Procedure a Bargain? Evidence From U.S. Bankruptcy Courts* (Yale Int'l Center for Fin., Working Paper No. 03-13, 2003).

225. See Thorburn, *supra* note 203, at 339, 351-54 (noting that the more intangible the assets, the more chances it had to be sold as a going concern).

found in Chapter 11 firms, refuting the notion that auctions eliminate efficient firms. The same study also found that direct costs of auctions were similar to the direct costs of Chapter 11 reorganizations.²²⁶ However, indirect costs were found to be much lower due to the short time an auction takes—two months from filing to completion of sale—as compared to the time spent by firms in a Chapter 11 procedure—between two and three years.²²⁷ This study also revealed that in going-concern auctions debt recovery rates for creditors were similar to rates found in Chapter 11 reorganizations.²²⁸ Another study found firms that survive an auction-only bankruptcy regime are more likely to emerge as healthy enterprises with post-bankruptcy performance on par with industry rivals; Chapter 11 firms, in contrast, systematically under-perform compared to their peers.²²⁹ This study also concluded that even the absence of absolute priority violations from auction sales does not create a problem as proponents of such violations might argue, due to CEO countervailing activity, which mitigates any eve-of-bankruptcy “going for broke” attempts by shareholders.²³⁰

Baird’s solution prompted several other proposals for reforms, which basically rehearsed his mandatory auction procedure but offered to modify specific aspects in it. For example, Robert Hansen and Randall Thomas have argued for a combination of the existing bankruptcy regime with an auction as a default, to be executed immediately upon rejection of a reorganization plan by claimants.²³¹ Elazar Berkovitch, Ronen Israel, and Jaime Zender have suggested the use of a restricted auction mechanism. According to this mechanism, once the firm files for bankruptcy, if the creditor refuses to renegotiate the original loan terms, the court strictly enforces the pre-bankruptcy contracts made by the firm. If the creditor agrees to a formal bankruptcy procedure, the firm is auctioned but the creditor does not participate.²³² Their proposal effectively increases the firm’s bargaining power when reorganization is the efficient outcome.

226. Nevertheless, when liquidated or sold as a going concern following a pre-pack, auctioned firms demonstrated lower direct costs. *See id.* at 366.

227. *Id.* at 339-40, 354-60.

228. *Id.* at 340, 360-65 (indicating that overall, claimants recover 35% of the face value of their claims, with a 27% mean recovery rate for piecemeal liquidations and 39% recovery for going concern sales. The median overall recovery found in reorganizations is 41%; this is similar to firms auctioned as going concerns).

229. *See* B. Espen Eckbo & Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 J. FIN. ECON. 227, 229 (2003).

230. *Id.* at 228-30.

231. *See* Hansen & Thomas, *supra* note 158, at 178-82 (claiming that the auctions should be conducted in a similar manner to the auctioning of solvent firms, e.g., with the help of investment bankers).

232. Elazar Berkovitch, Ronen Israel & Jaime F. Zender, *The Design of Bankruptcy Law: A Case for Management Bias in Bankruptcy Reorganizations*, 33 J. FIN. & QUANTITATIVE ANALYSIS 441, 453-55 (1998).

Francesca Cornelli and Leonardo Felli have proposed to auction only a control stake of the firm—50% of the shares plus one—thus enabling the buyer of the control stake to accept a reorganization plan that would maintain the firm as an ongoing concern.²³³

Another important suggestion was made by Mark Roe, who pioneered a proposed reform of bankruptcy laws in 1983. The purpose of these reforms was to divert decisions made within the collective procedure of large, publicly-traded firms to the market.²³⁴ Roe had suggested the adoption of a simple all-common-stock capital structure for any reorganizing firm by selling a slice of the reorganizing firm's stock—for example, 10% of the stock—to the market, which would provide an extrapolation of the firm's entire value.²³⁵ The market's valuation would subsequently be adopted by the court and the remaining stock be distributed to claimants according to the absolute priority rule. Adopting such a reform would significantly cut out procedural costs and increase the accuracy of the value attached to the reorganizing firm depending on the market's price efficiency,²³⁶ and lack of imperfections.²³⁷

The auction solution has been criticized as being based on false assumptions of perfect capital markets and zero, or near zero, transaction costs.²³⁸ It has been argued that this description of an optimal world, made by efficient market advocates, is inaccurate due to serious market imperfections such as the market response to time-pressured sales of "illiquid" assets in offering prices below "market" value,²³⁹ asymmetric information,²⁴⁰ and significant transaction costs, such as difficulties in communicating and coordinating the actions of many claimants.²⁴¹

233. See Cornelli & Felli, *supra* note 79, at 478.

234. See Roe, *supra* note 67, at 529, 559.

235. *Id.* Roe assumes that markets have a homogenous view of risk. *But see* Rasmussen, *Efficiency*, *supra* note 69, at 326 n.26 (questioning Roe's view on the market's view of risk).

236. A market is price-efficient to the extent it can quickly and accurately reflect public information in stock prices.

237. See Roe, *supra* note 67, at 530-31, 559-62 (indicating the market's effectiveness in assessing a variety of traded securities under different conditions; direct evidence regarding bankrupt or post-bankruptcy firms is scarce).

238. See LoPucki, *Strange Visions*, *supra* note 92, at 80, 97-106; Skeel, *supra* note 157, at 480-81.

239. See LoPucki, *Strange Visions*, *supra* note 92, at 100 (presenting supportive evidence).

240. See Adams, *supra* note 145, at 153-55.

241. See LoPucki, *Strange Visions*, *supra* note 92, at 101-03.

2. Auctions in Imperfect Markets

The auction solution might work well when markets operate perfectly. But a line of reform proposals assumed as its baseline assumption, the existence of imperfect markets in which transaction costs are high since cash is sometimes hard to raise²⁴² and competition among bidders is scarce,²⁴³ and problems of asymmetric information exist as firms in financial distress are often undervalued. These proposals have tried to overcome the imperfect markets predicament.

In a seminal article from 1988, Lucian Bebchuk suggested an “options approach.”²⁴⁴ Starting at the end, the old capital structure of the firm is cancelled, and the reorganized company (“RC”) is declared to have a simple capital structure of 100 equal units.²⁴⁵ The value of 100 RC units is, of course, the question, to be decided by implementing the following scheme.²⁴⁶ The basic principle is that claimants are awarded options for the firm’s securities; the exercise of which will result in a distribution of these securities among claimants according to the true estimates held by claimants of the firm’s value.

For an initial period of time, the 100 units of RC would be retained by the company or a clearing agent and each senior creditor would receive a type-A right which the company can redeem by paying that creditor his debt in full. If not redeemed, however, each senior creditor will receive RC units in a pro-rata distribution according to the size of his claim against the firm. Junior creditors would receive type-B rights, which again would be redeemed by the company in exchange for the junior creditors’ debt being paid in full. If not redeemed by the company, however, holders of type-B rights have the option to buy units of RC. Each unit would be available at a

242. See Aghion et al., *Economics*, *supra* note 199, at 527-28; Aghion et al., *Improving*, *supra* note 48, at 855-56, n.17 (finding empirical support for this conclusion in evidence from initial public offerings (IPO’s), workouts, and takeovers. For example, assume the bankrupt firm (the authors offer IBM) has an expected value of \$100 billion. Small bidders do not have that kind of money, “going public” will consume time, and a small group of wealthy investors will bid in discount in light of the immense risk undertaken by them should they decide to bid (the total sum of bids for specific assets can be higher than a bid for the entire firm). The natural group to approach as bidders is that of the former claimants of the firm).

243. See Aghion et al., *Economics*, *supra* note 199, at 528 (noting that not all potential bidders will participate in an auction, since preparing bids is costly. Only the winner in the auction would retrieve his expenses, thus an entry deterrent is created).

244. See Bebchuk, *New Approach*, *supra* note 40. See also Bebchuk, *Using Options*, *supra* note 78, at 840 (relating the options approach to the Black-Scholes characterization of any corporate security as an option with respect to the firm’s assets).

245. See Bebchuk, *Using Options*, *supra* note 78, at 834 (noting that a superior capital structure might be adopted at the end of the process, when the new owners of RC are defined).

246. In other words, the value of the firm is not verifiable by courts.

price equal to the senior creditors' debt divided by 100. The shareholder would receive type-C rights which cannot be redeemed by the company, but award its holder the option to purchase RC units at an exercise price equal to both senior and junior creditors' debt divided by 100. If type-C holders wished to exercise their option, they would buy 100 units of RC equivalent to the ownership in the reorganized company, in return for a sum of money which the company would use to redeem type-A and type-B rights, which would pay off the debts of both senior and junior creditors). If type-C holders do not wish to exercise their option but type-B holders would like to exercise theirs, type-B holders would buy RC in exchange for a sum of money equal to the debt owed to type-A holders, which the company will use to redeem type-A rights. If no type-C and type-B options were exercised, type-A holders would receive the units of RC and would become owners of the reorganized company. The scheme also allows for a fraction of each group to exercise the option given to it.²⁴⁷

Bebchuk's options approach results in a new, simple capital structure for the firm, and renders redeployment of its assets easy enough where the new owners—the holders of the RC units at the end of the process—will decide the fate of the firm.²⁴⁸ As in the auction solution, the redeployment decision is separated from the distribution decision. This sophisticated scheme also distributes the proceeds of the hypothetical sale in accordance with the absolute priority rule,²⁴⁹ and makes each claimant unable to complain.²⁵⁰ It is also quick in rescuing firms from bankruptcy.²⁵¹ Moreover, the scheme is decentralized and does not require coordination among claimants.²⁵² Most importantly, Bebchuk's proposed reform does not depend on the market to accurately value the firm or to facilitate the options process.²⁵³

On the other hand, Bebchuk's procedure suffers from several important problems. First, junior claimants need to invest additional capital, rendering cash constrained claimants unavailable to participate in the scheme.²⁵⁴ Second, in order to participate, claimants need to know a lot

247. See Bebchuk, *New Approach*, *supra* note 40, at 787-88.

248. See Bebchuk, *Using Options*, *supra* note 78, at 837.

249. Notice, however, that other distribution schemes are also possible under the options approach. See *id.* at 834.

250. See Bebchuk, *New Approach*, *supra* note 40, at 790-92 (noting that each claimant is either being paid in full or receiving shares in the reorganized company, when—as a matter of objective reality—there is nothing more to give).

251. See Bebchuk, *Using Options*, *supra* note 78, at 842 (noting that the scheme improves ex post efficiency and requires only a short timeline to implement).

252. *Id.* at 839.

253. See Bebchuk, *New Approach*, *supra* note 40, at 789-90.

254. See Bebchuk, *Using Options*, *supra* note 78, at 839 (arguing that when public companies are the subject matter, claimants usually hold only small fractions of the

about the firm and its prospects. Although trading options in the market can reveal information, there is no bargaining among claimants that, as the current bankruptcy regime proves, might be a source for information exchanges.²⁵⁵ Third, participants in the scheme should be sophisticated enough. However, sometimes participants, especially junior creditors, are not very sophisticated and they may be unwilling to become shareholders.²⁵⁶

Bebchuk's proposed reform was subject to several modifications. Philippe Aghion, Oliver Hart, and John Moore have suggested that firms solicit cash and non-cash bids,²⁵⁷ or offer reorganization plans before the claimants exercise their options. These actions were supposed to increase the information available to claimants and the chance that they would make a better decision.²⁵⁸ They have also suggested replacing the mechanism advocated by Bebchuk with the simpler decision-making process of an investment banker, deciding how much the firm is truly worth according to bids solicited.

Ben Branch suggested setting the expiration date of the options extended to creditors to more than a year after the bankruptcy procedure is initiated. This would allow the market to observe the post-bankruptcy performance of the firm, including audited information, and to assess the firm's ongoing concern value.²⁵⁹

Oliver Hart, Rafael La Porta Drago, Florencio Lopez-de-Silanes, and John Moore have suggested a multiple auctions procedure designed to work even in inefficient markets.²⁶⁰ Once a collective procedure is initiated, 100 units of common security called "Reorganization Rights" (RRs), which reflect ownership in the firm, are issued to senior creditors pro-rata. RRs can be redeemed by lower-ranking creditors for an amount

investments in the reorganized company; that claimants can borrow money using their options as collateral; and that claimants can sell their options in the market).

255. See Bebchuk, *Using Options*, *supra* note 78, at 840.

256. Jochen Bigus, *Bankruptcy Law, Asset Substitution Problem, and Creditor Conflicts*, 22 INT'L REV. L. & ECON. 109, 128 (2002).

257. In a non-cash bid, the bidder offers securities in the reorganized firm instead of cash. See Aghion et al., *Improving*, *supra* note 48, at 862. However, soliciting non-cash bids could be a source for inefficiencies. See Matthew Rhodes-Kropf & S. Viswanathan, *Corporate Reorganizations and Non-Cash Auctions*, 55 J. FIN. 1807 (2000).

258. Aghion et al., *Economics*, *supra* note 199, at 532-36. Their proposal was carved initially for Eastern European countries. See *id.* at 543-45. See also OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 169-83 (1995).

259. Branch, *supra* note 51, at 60-62. His reform includes additional changes, such as in the governance structure of the reorganized firm. See *id.* at 62.

260. Hart et al., *supra* note 48. Their procedure is designed to overcome a situation where capital markets cannot be relied on to objectively evaluate—and rank—reorganization plans, which are based on cash and non-cash securities. The procedure therefore can serve countries with developing economies or economies in transition.

which pays the senior creditors' debt and may be redeemed again by even lower ranking claimants, and so on. Once this stage is completed, a public auction is conducted, and outsiders can bid for the RRs and buy them from claimants who currently hold them. Finally, RR holders collectively decide the fate of the firm, including the possibility of liquidation. The initial inside auction is conducted in order to prevent outsiders from bidding a false value for the RRs.²⁶¹

Barry Adler and Ian Ayers have suggested a dilution mechanism to derive a market valuation of the firm.²⁶² According to their scheme, the court would issue 100 shares of the reorganized firm to senior creditors, and then solicit schedules of offers to buy or sell the shares at a fixed price of \$1 per share.²⁶³ However, the offers would be conditioned upon a particular number of additional shares being issued to the junior creditors. The court would first issue shares to junior creditors up until demand was less than or equal to supply. Afterward, they would carry out sales of the reorganized firm's shares from senior to junior creditors. For example, assume the classic valuation conflict: senior creditors argue that the reorganized firm's shares are worth \$90, but the true share value is \$150. At a fixed price of \$1 per share, junior creditors would have an incentive to draw a demand schedule that offers to buy 100% of the senior creditors' shares, as long as the junior claimants are issued less than fifty dilution shares.²⁶⁴ Conversely, senior creditors would have an incentive to draw a supply schedule that offers to sell all of their shares, as long as more than fifty diluting shares are issued.²⁶⁵ The equilibrium created reflects the true value of the firm.

3. Criticism on Reform Proposals for Imperfect Markets

The ingenious reform proposals discussed above are not free from difficulties. First, critics argue that the residual owner's incentives are not always perfectly aligned with those of the firm. For example, an unsecured creditor who is a supplier of the firm might be interested in an inefficient continuance of the firm simply in order to guarantee his future income. Thus, attempting to entrust the important redeployment decision to individuals whose initial interests were not identical to those of the residual owner can be dangerous. Secondly, it has been argued, and empirically

261. Hart et al., *supra* note 48, at 466-67.

262. Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83 (2001).

263. *Id.* at 101.

264. *Id.* at 104. When there are fewer than fifty diluting shares, every share is worth more than \$1 (firm value of \$150 divided by the total number of shares).

265. *Id.* at 105. When there are more than fifty diluting shares, every share is worth less than \$1 and senior creditors have an incentive to sell their shares.

corroborated, that once the firm is financially distressed, a single and identifiable class of residual owners does not always exist.²⁶⁶ Indeed, when the value of the firm is uncertain and volatile, the likelihood that the range of possible values will stretch across different layers of claimants is great.

Notwithstanding the theoretical argument, the solutions offered to improve the auction mechanism are imperfect. For example, it has been argued that in a debate over the need for an early shutdown, these proposals also entrust the decision to the hands of unskilled players and create incentives for players to withhold information from decision-makers.²⁶⁷ Another example lies with honoring the absolute priority rule. As much as deviations from absolute priority are beneficial, the reform proposals aimed at avoiding such deviations miss the point. Yet another argument addressed the fact that reforms proposed do not solve vexing problems such as the need to value a secured creditor's collateral in order to implement the scheme.²⁶⁸

One must acknowledge that even market-based reforms generate costs. For example, studies conducted in other contexts show that market offerings carry significant costs in underwriter compensation and other administrative expenses.²⁶⁹ Indeed, one cannot assume that potential buyers have a priori sufficient information about the firm. Thus, a preliminary inquiry by such prospective buyers is inevitable. For example, the ex ante costs created by reform proposals may not ultimately prove to be lower than the same costs as incurred under current Administrative Models.²⁷⁰

Finally, and most importantly, schemes such as the options approach or the dilution mechanism do not solve situations in which claimants are cash-constrained²⁷¹ or unsophisticated investors.²⁷² Replacement of such

266. LoPucki, *The Myth*, *supra* note 99, at 16. LoPucki found in his study that in 62% of large public company reorganizations, a single class of residual owners could not be identified. Instead, two or more classes of claimants with conflicting interests, as far as the firm's investment policy is concerned, shared the marginal dollar of gain or loss. *Id.* at 22.

267. Baird & Morrison, *supra* note 26, at 370-71.

268. Bebchuk & Fried, *New Approach*, *supra* note 205, at 2408-09. But see the reform proposed by the authors at 2409.

269. See Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 354-57 (1997).

270. See Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1164.

271. Adler & Ayres, *supra* note 262, at 104 n.49, 119; LoPucki, *Comment*, *supra* note 75, at 713. To illustrate, imagine a public corporation with 20,800 shareholders, as in the case of Manville. Assume that according to the Bebchuk scheme, a notice would be sent to each of Manville's shareholders, notifying them that they have two choices. First, they may pay their pro rata share of the firm's debt, totaling \$2.8 billion, meaning each share needs to contribute \$129,000. Alternatively, they could lose their equity interest in the firm, which upon confirmation would be worth \$1,000. LoPucki would ask us to imagine our own mother, living on social security, as one of the shareholders, and her reflection on whether to take a huge loan to invest in a bankrupt company.

claimants is difficult due to transaction costs,²⁷³ and because often one's valuation of the firm strongly depends on his or her identity: "insiders" attach higher values than "outsiders."²⁷⁴

III. INTRODUCING THE BETTER POSITIONED AGENT

A. *Mission Statement*

Each of the two models discussed above suffers from shortcomings that curtail their ability to guarantee optimal redeployment of a financially-distressed firm's assets. Obviously, the Residual Owner Model poses a real challenge to bankruptcy lawmakers, as harnessing it would generate the advantages of making market-influenced decisions. The following discussion will introduce a new approach to corporate bankruptcy decision-making that builds upon an important insight developed by the Residual Owner Model's proponents: allocating decision-making power to market agents. This method introduces a new ideology as its driving force, redistributing, albeit selectively, value from one agent to another. It will be argued that carefully crafted redistribution—a change in pre-bankruptcy entitlements—can uniquely improve the outcomes of any given bankruptcy procedure and exposing redistribution as an essential and indispensable component of any corporate bankruptcy intervention.

This new approach assumes that the redeployment decision is actually split into several redeployment decisions along a timeline. In other words, redeployment does not consist of one decision, but of several decisions made at different points in time. The role of the Bankruptcy Court should be to allocate these redeployment decisions upon each occurrence to a different market agent, according to that agent's comparative advantage over other possible decision-makers. For example, during the period of time *prior* to the commencement of a bankruptcy procedure, the agent better positioned to control redeployment might be—as Part III of the Article shall demonstrate—a dominant secured creditor who is able to monitor the firm and intervene in its deterioration towards insolvency. The secured creditor could, for example, accelerate the date of a formal bankruptcy proceeding against the wishes of the management of the firm. Indeed, the commencement of a corporate bankruptcy proceeding marks the beginning of a series of actions by the Bankruptcy Court to allocate redeployment decisions, respectively, to several better positioned agents.

272. Adams, *supra* note 145, at 155-56. However, Adler and Ayres have offered to combine their solution within an Administrative Model, in a way that would overcome such difficulties. See Adler & Ayres, *supra* note 262, at 140-48.

273. Adams, *supra* note 145, at 156.

274. See Adler & Ayres, *supra* note 262, at 143.

The first action of the Bankruptcy Court should, according to this new approach, consider the fact that by the time the bankruptcy proceeding is initiated, the firm's dominant secured creditor should have already made his move and that if the secured creditor did not rise to expectations, he should be "punished." Is it a possible approach? The next section of this Article will argue that this approach is possible, despite a problem of asymmetric information that burdens any attempt to thus consider the dominant secured creditor.

Of course, a dominant secured creditor of a small- or medium-sized firm during the time prior to the commencement of a formal bankruptcy proceeding is not the only BPA. For example, other BPAs—regarding a decision as whether to continue a reorganization effort—or the owner/shareholder of the firm—in a decision whether to sell the firm to an outsider—could be a new supplier of finance. Note that all BPAs share a common quality; they are each interested in promoting their own selfish interest. But allowing them to freely follow their own interest in a corporate bankruptcy event might decrease social wealth. Corporate bankruptcy law is necessary to properly align such interests and accurately mold incentives so that their decisions will promote overall wealth. Of course, this is no easy task; however, it may be possible.

Furthermore, accepting the Better Positioned Agent approach as a possible redeployment model means accepting the problems such an approach engenders. Indeed, corporate bankruptcy law is all about trade-offs. A social engineer may decide to opt for the Better Positioned Agent approach rather than a market auction solution. Doing so means that the engineer believes that the market in which the firm's assets would be auctioned is too thin and that coping with an agency problem, for example, in order to harness the Better Positioned Agent approach, is preferable. Such an engineer thus chooses to trade off the shortcomings of an auction in a thin market with the agency problem that accompanies the Better Positioned Agent approach.

The discussion in Part III of this Article shall demonstrate the Better Positioned Agent approach as it can be applied in only one corporate bankruptcy decision-making context. The possibility of applying the new approach in other corporate bankruptcy decision-making contexts shall be left for future discussion. Future research should examine whether an owner/shareholder of a closely-held firm could be utilized as a BPA when a final decision is needed regarding redeployment. Additionally, it could be examined whether a new supplier of finance could be utilized as a BPA once the firm enters a formal bankruptcy procedure; thus postponing final redeployment in order to thoroughly explore possible ways to exploit the assets of the firm.

B. The Advantages of the New Approach

Assuming that this new approach proves feasible in the context of a secured creditor in relation to the period of time prior to the initiation of a formal bankruptcy procedure, one may ask what advantages the approach might yield.

The new approach can, at a minimum, supplement either the Residual Owner Model or the Administrative Model. The following discussion describes the advantages using the new approach as such a supplement. Furthermore, several of the advantages listed below may also be implemented in other corporate bankruptcy decision-making contexts as well.

First, the most important advantage of the Better Positioned Agent approach lies in the fact that it undermines the assumption that making good decisions regarding redeployment is a process that starts only after the initiation of a formal bankruptcy procedure. On the contrary, the Better Positioned Agent approach assumes that decision-making power should sometimes be expropriated from the firm and its managers even sooner! The model acknowledges the possibility of making relevant redeployment decisions even before a formal collective procedure is commenced. While the execution of the Administrative and the Residual Owner Models' redeployment decision depends on the relatively arbitrary factor of the timing of the bankruptcy filing and the initiation of a formal bankruptcy procedure, the Better Positioned Agent approach is independent of such arbitrariness. The new approach can result in redeployment before the initiation of any formal bankruptcy procedure. The Better Positioned Agent approach covers a period of time that until now has not been considered relevant to making wealth increasing decisions. To the extent that the firm deteriorates into insolvency, the new approach can halt the deterioration process sooner than the other two models.

Second, for the Better Positioned Agent approach to be implemented, no assumption is necessary regarding any agent's sophistication. Recall that according to proposals made in the line of the Residual Owner Model, agents participating in the schemes needed to be sophisticated enough to know about the firm and its prospects and to perform atypical tasks such as raising funds for investment or calculating investment possibilities. The Better Positioned Agent approach, however, requires that each agent only perform tasks in areas where he has specialized. Moreover, the new approach actually seeks the agent most efficient to perform each task. The Better Positioned Agent approach thus better confronts the risk of market actors miscalculating the firm's true value. Indeed, the new approach entrusts this mission only to the hands of qualified actors.

Third, the market has no bearing on the viability of the implementation of the Better Positioned Agent approach. The relevant market might as well be imperfect. The Better Positioned Agent approach relies on certain market actors known to possess required qualities, but need not depend on the market being able to supply such actors.

Fourth, the Better Positioned Agent approach focuses directly on shortening the length of the formal bankruptcy procedure, and the delays that plague it, thus saving on bankruptcy costs. This characteristic flows straight from the fact that the Better Positioned Agent approach is time-oriented.

Fifth, the debate about corporate bankruptcy has raised doubts as to whether a mandatory redeployment process is necessary and whether agents are not able to independently allocate control rights efficiently to the appropriate market agents. Still, even if this is the case, as long as there is an opt-out opportunity for certain agents, in the form of a collective procedure that alters pre-bankruptcy entitlements, formal bankruptcies may ensue. In such a world, one would prefer to have an optimal decision-making mechanism to dominate the formal bankruptcy system, rather than putting faith solely in informal, even efficient, mechanisms. In this respect, the Better Positioned Agent approach is necessary for any attempt to overcome the problems of financial distress with a formal bankruptcy procedure.

Still, the Better Positioned Agent approach does not purport to become the center of attention during the process of redeployment. Rather, this new approach operates as a back-up system to any simple redeployment move deemed desirable by the bankruptcy system. For example, the new approach can be applied along with a simple auction, and to rescue value that otherwise would have been lost in the simple auction.

Finally, another advantage of the new approach concerns the idea that corporate bankruptcy regimes should reduce the extent to which the economy relies upon formal bankruptcy procedures rather than out-of-court restructurings and reorganization to accomplish the task of solving financial distress. Indeed, the new approach demonstrates not only the need to rely on market mechanisms to execute the redeployment decision, but also that reducing total reliance on formal bankruptcy proceedings is possible. Recall, that this advantage of the Better Positioned Agent approach suppresses two sources of efficiency costs. First, there are the obvious costs that result from not making optimal redeployment decisions. Second, there is the more subtle source of efficiency costs, which are incurred when redistributive impulses are triggered during formal bankruptcy procedures, or in other words, the costs attributed to the problem of preservation.

In order to highlight the insights offered by the Better Positioned Agent approach and enhance its relevance, the following discussion adopts as a prototypical model not the large, publicly traded company, but rather the small- or medium-sized private company. Indeed, the latter kind, rather than the former, occupies most of the Bankruptcy Court's docket. Generally speaking, a typical small- or medium-sized firm is privately held, and its debt structure consists of one senior lender, a bank, and other unsecured creditors, most of whom are trade creditors.²⁷⁵

IV. DEMONSTRATING THE NEW APPROACH: THE CASE OF THE DOMINANT SECURED CREDITOR

A. *The Economic Background*

1. Assignment of Control Rights

Conventional wisdom now recognizes that optimal redeployment of the assets of a financially distressed firm emanates from proper allocation of control rights over these assets.²⁷⁶ The only issue that remains is how the control rights are to be allocated—by contract or by law. The division between contractual allocation and legal allocation of control rights involves the question of whether an efficient allocation pattern of control rights exists or is necessary.

The idea that the law should assign control rights over the assets of an insolvent firm to qualified agents is not new;²⁷⁷ however, commentators have argued recently that investors can allocate successfully the rights to control the assets of the firm in case of financial distress without needing legal intervention.²⁷⁸ In accordance with this argument, control rights now are allocated dynamically and coherently—through the corporate charter, securities issued by the firm, debt contracts entered by the firm, and non-bankruptcy law²⁷⁹—to agents that are capable and driven by appropriate

275. A recent study conducted in Britain supplies valuable data, assembled from nonpublic information sources regarding 542 small- to medium-sized financially distressed firms. See Julian Franks and Oren Sussman, *Financial Distress and Bank Restructuring of Small to Medium Size UK Companies*, 9 REV. FIN 65 (2005).

276. See, e.g., Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004) [hereinafter Westbrook, *Control of Wealth*]; Jay Lawrence Westbrook, *Bankruptcy Control of the Recovery Process*, 12 AM. BANKR. INST. L. REV. 245 (2004).

277. See Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001) [hereinafter Baird & Rasmussen, *Control Rights*].

278. See Baird & Rasmussen, *The End*, *supra* note 6, at 778.

279. For examples of control rights, see Baird & Rasmussen, *The End*, *supra* note 6, at 782-85.

incentives to make sensible redeployment decisions.²⁸⁰ This argument has not been verified empirically.²⁸¹ Nevertheless, even the most enthusiastic supporters of this position cannot guarantee that the allocation of control rights will always ensure optimal decision-making. Furthermore, these scholars admit that proper allocation of control rights varies among different corporations over time and across economic domains.²⁸² Settling for such a vague allocation of control rights is perhaps too optimistic and may be irresponsible.²⁸³ For example, entrusting secured creditors with control rights that are too broad creates problems. Moreover, secured creditors are not incentivized to maximize value to the benefit of other claimants during an auction of the firm's assets.²⁸⁴

It is not clear whether the role of corporate reorganization law has become somewhat minor. This is a matter that should be resolved empirically and requires careful reexamination for each jurisdiction. Nonetheless, even as a remnant redeployment tool, the law should be designed to promote efficiency. The following discussion assumes the necessity of designing a specific efficient legal arrangement for the assignment of control rights.

To whom should control rights be legally allocated? The discussion in the preceding sections has revealed that the fundamental problem emanates from an inability to identify the agent or agents who possess the correct set of redeployment incentives. Claimants of the firm are aligned in a vertical order of seniority, and identifying the particular agent—or class of agents—with the correct incentives requires that the true value of the firm's assets be known. Elucidation of the firm's assets is not a feasible task, so a new approach must be designed. While the new approach recognizes that transfer of control rights to the unattainable residual owner is not an option, it nevertheless suggests that a market actor be assigned those rights.

2. The Role of Redistributive Impulses

The idea that redistributive impulses—for example, violating the absolute priority rule—during a formal bankruptcy procedure could improve corporate bankruptcy decision-making, the center of which

280. See *id.* at 778-82.

281. See *id.*; Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645 (2003); Westbrook, *Control of Wealth*, *supra* note 276, at 829 ("There is support for the assertion that lenders have achieved control in some very prominent recent cases, but they do not offer evidence to support the claim that this control results from contracts that pre-date the debtor's financial distress.").

282. See Baird & Rasmussen, *The End*, *supra* note 6, at 779.

283. Cf. Westbrook, *Control of Wealth*, *supra* note 276, at 824.

284. See *id.* at 843-44.

concerns the appropriate allocation of control rights, is also a familiar concept. For example, Professors Baird and Rasmussen recently suggested that a formal bankruptcy procedure should allow shareholders to bargain for equity in the reorganized firm. They argue for this type of bankruptcy configuration despite violation of the absolute priority rule in order to salvage the ongoing concern surplus—which depends on the shareholders' participation in the firm—and mitigate delay attempts by these agents.²⁸⁵

However, it remains to be determined whether absolute priority violations are an ad-hoc improvement offered to lawmakers contemplating an Administrative Model bankruptcy procedure, or if they are an integral part of the bankruptcy endeavor that should be accepted by those considering a formal Residual Owner Model bankruptcy. Indeed, to the extent that they acknowledge the need to violate the absolute priority rule in favor of shareholders of the firm, Baird and Rasmussen limit their argument to the context of the Administrative Model. Moreover, systematic violations of absolute priority—for example, in a context other than that of the shareholders—are generally not part of corporate bankruptcy theory.

The phenomenon of deviations from the absolute priority rule has been observed and evaluated within the confines of the Administrative Model.²⁸⁶ Consequently, absolute priority violations could not be described as an integral part of the corporate bankruptcy regime. Furthermore, most studies focused on one particular absolute priority violation—that which guarantees shareholders of the firm a certain share in the reorganized firm on account of creditors.

Indeed, several explanations have been offered to clarify why shareholders of a financially distressed firm, contrary to an ex ante written contract, exit a formal bankruptcy procedure or an informal workout with value, while higher-ranking claimants have not been paid in full.²⁸⁷ For example, it has been argued that shareholders of financially distressed firms enjoy considerable bargaining power because they are able to threaten creditors with delay of the exit from the long and costly formal bankruptcy procedure unless creditors agree to specific concessions.²⁸⁸ Others have argued that shareholders' considerable bargaining power derives from their

285. See Baird & Rasmussen, *Control Rights*, *supra* note 277, at 952-53.

286. See Yaacov Z. Bergman & Jeffrey L. Callen, *Rational Deviations from Absolute Priority Rules*, 4 INT'L REV. FIN. ANALYSIS 1, 1 (1995) (containing a list of studies documenting the phenomenon).

287. Several, although not all, explanations have focused on the shareholders' relatively strong bargaining position in relation to creditors.

288. See Lucian Arye Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 255-56 (1992); Franks & Torous, *supra* note 117, at 747-48.

assumed unique ability to preserve firm value.²⁸⁹ Another explanation is that creditors are complaisant to asymmetric information, which allows shareholders to misrepresent opportunistically their true contribution to the firm's success.²⁹⁰ Still another explanation points to shareholders control—through management—over investment decisions of the firm, which enables them to threaten creditors with sub-optimal investment decisions that would reduce the value of the firm during financial distress.²⁹¹ It also has been argued that shareholders, who are given exclusivity in structuring reorganization plans under the terms of American Chapter 11, extract concessions by making “take it or leave it” offers to creditors.²⁹²

Recently, it has been argued that deviations from absolute priority in favor of shareholders emanate from uncertainty over the result of a future judicial valuation to be conducted during the bankruptcy procedure, which in turn equips shareholders with considerable bargaining power.²⁹³ Another recent study found evidence suggesting that deviations from absolute priority in favor of shareholders mitigate an agency problem generated when shareholders/managers are given exclusive control over the firm during reorganization.²⁹⁴ It has further been argued that allowing shareholders to receive value in bankruptcy induces ex post optimal timing of the firm's default.²⁹⁵

B. Employing the Secured Creditor to Improve Redeployment

Will erosion or denial of secured creditor protection, which is an additional violation of the absolute priority rule, improve corporate bankruptcy decision-making?

289. See Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 748 (1988).

290. See Ronald M. Giammarino, *The Resolution of Financial Distress*, 2 REV. FIN. STUD. 25, 27 (1989).

291. See, e.g., Yaacov Z. Bergman & Jeffrey L. Callen, *Opportunistic Underinvestment in Debt Renegotiation and Capital Structure*, 29 J. FIN. ECON. 137 (1991); Bergman & Callen, *supra* note 286, at 2-4 (containing a list of studies arguing a similar point).

292. Pierre Mella-Barral & William Perraudin, *Strategic Debt Service*, 52 J. FIN. 531, 532-33 (1997). See also Ronald W. Anderson & Suresh Sundaresan, *Design and Valuation of Debt Contracts*, 9 REV. FIN. STUD. 37, 44 (1996).

293. See Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006).

294. See Dina Naples Layish, *A Monitoring Role for Deviations from Absolute Priority in Bankruptcy Resolution*, 12 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 377 (2003).

295. See Pierre Mella-Barral, *The Dynamics of Default and Debt Reorganization*, 12 REV. FIN. STUD. 535, 536-37 (1999).

1. Literature Review

The question presented here—improving corporate bankruptcy decision-making by specifically eroding secured creditor protection during a bankruptcy procedure—has been indirectly discussed in the literature. Indeed, the well-known controversy regarding the efficiency of secured credit in general, a debate which seems to be never-ending,²⁹⁶ is relevant to our purpose since the provision of full priority to secured creditors over other creditors during bankruptcy came under attack. Ex post efficiency reasons were briefly cited in this context. In other words, while erosion of secured creditors' full priority has been acknowledged to have a certain efficiency effect, many questions were left unanswered, including the questions of why erosion of secured creditors' full priority in bankruptcy improves efficiency, and how erosion of secured creditors' full priority in bankruptcy—rather than outside bankruptcy, for example—improves efficiency.

It is important to note that the question of eroding secured creditors' full priority can be addressed in two contexts: with regard to firms in a formal bankruptcy procedure, and with regard to any firm, even if its financial difficulties do not trigger a formal bankruptcy procedure.²⁹⁷ As we are interested in corporate bankruptcy decision-making, we focus our attention on the first context.

The concept of erosion of secured creditors' full priority in bankruptcy is likely rooted in the debate over the efficiency of secured credit in general. The general view among scholars and lawmakers is that affording full priority to secured claims in bankruptcy is socially desirable.²⁹⁸ However, several commentators take a different stand. It has been acknowledged in this context that while secured lending offers several

296. See Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117 (2002).

297. Only two proposals seem to have been raised as general erosion-of-priority reform for secured lending, rather than being bankruptcy-related. See Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759 (2004). One proposal was Professor Elizabeth Warren's carve-out proposal, which advocated that up to 20% of the collateral be reserved for unsecured creditors. See Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1469 (1997). The other was several scholars' proposal to give tort creditors priority over secured creditors. See David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643-49 (1991); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994); Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Creditor System: Asbestos Time, the Worst of Times*, 36 STAN. L. REV. 1045, 1080-85 (1984). For a general discussion of the appropriate priority for tort creditors in bankruptcy see Note, *Switching Priorities: Elevating the Status of Tort Claims in Bankruptcy in Pursuit of Optimal Deterrence*, 116 HARV. L. REV. 2541 (2003) [hereinafter Note, *Switching Priorities*].

298. See Note, *Switching Priorities*, *supra* note 297, at 2551.

efficiency advantages, debtor-firms themselves deliberately refrain from granting security interests for all assets of the firm to lenders, even though they will not be able to secure the “the last penny’s worth,” as such a pattern of secured lending would undermine the secured creditor’s incentive to monitor the firm for management misbehavior.²⁹⁹ Monitoring in this context has been defined as minimizing the agency costs associated with the risk of management misbehavior. These agency costs were said to be borne entirely by the firm, as the price of loans required by creditors rises. It, therefore, has been argued that the firm will avoid granting security interests in all of its assets in an attempt to obtain the lowest level of monitoring costs and residual agency costs.³⁰⁰ It has been further argued that “there is undoubtedly a correlation between the value of a secured creditor’s debt claim and the time he spends monitoring for default”³⁰¹

As secured creditors’ incentives to monitor the firm’s activities and their superior monitoring technology came under inspection, commentators began to address, albeit with some degree of simplification, the issue of altering secured creditors’ incentives by eroding their full priority in bankruptcy.

Michelle White argued that awarding secured creditors full priority when the firm is liquidated may cause firms to continue operations when it is inefficient to do so.³⁰² Holding to the assumption of a coalition between the secured creditors and shareholders of the firm, who usually favor continuation over liquidation, White presented a model to conclude that full priority might result in inefficient firms staying in business.³⁰³

Thomas Jackson and Robert Scott have pointed to the fact that, on the eve of bankruptcy, secured creditors may have significant control over the firm’s decision-making process and that this control may be abused by the secured creditor to improve his own position.³⁰⁴ For example, the secured creditors may require the firm to sell property in order that they may be paid.

In a discussion of the British bankruptcy system, David Webb commented that a secured creditor

who is fully secured, is not going to worry too much if the company is making losses, provided his own security is not in jeopardy. By the time the bank starts worrying, any surplus there

299. See, e.g., F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1439-40 (1986).

300. See *id.* at 1440-41.

301. *Id.* at 1459.

302. Michelle J. White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550 (1980).

303. *Id.* at 563.

304. Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors’ Bargain*, 75 VA. L. REV. 155, 170, 173 (1989).

may have been to compensate unsecured creditors will have been eaten up by losses and those creditors will lose far more than they would have if the bank moved earlier.³⁰⁵

John Hudson, relying on Webb and making his argument within the context of the general secured credit debate, commented on the ex post efficiency cost associated with secured credit. While secured creditors are "principal whistle blower[s]" who can arrest the activities of failing firms at the optimal time, "in the circumstances of a secured loan there will be no incentive for the bank to use this knowledge optimally and will tend to keep failing firms in existence for too long"³⁰⁶ Hudson then reviewed several reform proposals to address the criticism over secured credit, such as abolishing secured credit altogether.³⁰⁷ Among other reforms, he mentioned the Cork Committee Report of 1982, which suggested that a 10% fund be taken from the secured creditor and surrendered to unsecured creditors to ensure that the latter enjoys a minimum value as a return.³⁰⁸

Lucian Bebchuk and Jesse Fried argued that secured creditors' full priority should be eroded and that secured creditors should not receive the entire amount of their secured claim in bankruptcy.³⁰⁹ They believe that full priority could give rise to inefficient contracting between a borrower and its creditors, and could create other types of efficiency costs as well.³¹⁰ Focusing upon the concept of "non-adjusting creditors," these authors discussed ex ante efficiency costs generated by a full priority regime:

under full priority, security interests will be used excessively [I]n a loan transaction that will go forward *whether or not a security interest is used*, full priority may cause the parties to incorporate an inefficient security interest into the arrangement, a security interest whose use in the arrangement reduces the total value available to all parties affected.³¹¹

Bebchuk and Fried attributed multiple efficiency costs to the full priority rule. In regard to ex post efficiency, they stated that

full priority can inefficiently reduce the [secured] creditor's incentive to enforce its loan contract with the borrower. In particular, full priority can give the creditor less incentive to enforce any loan contract covenants with the borrower or to force

305. David C. Webb, *An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain?*, 43 OXFORD ECON. PAPERS 139, 145-46 (1991).

306. See John Hudson, *The Case Against Secured Lending*, 15 INT'L REV. L. & ECON. 47, 51-52 (1995).

307. *Id.* at 57-62.

308. *Id.* at 59.

309. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1281-83.

310. *Id.* at 1283.

311. *Id.* at 1293 (internal citation omitted).

the borrower into bankruptcy when it would be socially desirable for the borrower to liquidate or reorganize [A] secured creditor that is well protected by collateral does not have sufficient incentive to call a default (or cut off funding) when the borrower's owners attempt to continue operating inefficiently in the hope of saving the business.³¹²

Bebchuk and Fried's recommendation was to adopt either a "fixed-fraction priority rule" or an "adjustable-priority" rule in place of a full priority rule.³¹³ The "fixed-fraction priority rule" dictates that a pre-determined fixed fraction of the collateral backing a secured claim—for example, 10%—would be made available to pay the claims of unsecured creditors.³¹⁴ An "adjustable-priority" rule requires that secured claims be afforded priority over claims of certain creditors, such as "non-adjusting creditors" or creditors who have explicitly agreed to be subordinated.³¹⁵ Another study indirectly acknowledged the importance of eroding a senior creditor's claim during a formal bankruptcy procedure. It has been argued that eroding a senior creditor's claim can affect the creditor's incentives to monitor the firm.³¹⁶

Finally, a note published by the Harvard Law Review has argued that elevating the priority of tort claims ahead of all other claims, including those of secured creditors, can be efficient in bankruptcy and would largely resolve the problem created when secured creditors insulate themselves against risk.³¹⁷ Indeed, the note's author argued that full priority abolishes the secured creditor's incentive "to monitor levels of precautionary investments taken by debtor firms,"³¹⁸ and that:

Creditors are in a good position to elicit information regarding levels of precaution, yet much of the incentive to do so is undermined by the bankruptcy regime. It is likely that large

312. *Id.* at 1317-18 (footnotes omitted).

313. *Id.* at 1321.

314. *Id.*

315. *Id.*

316. See Cornelli & Felli, *supra* note 79, at 477, 481-85. Note, however, that while recognizing a possible ex ante effect upon creditors' behavior, monitoring being the altered behavior, Cornelli and Felli's model focuses on a comparison of types of administrative bankruptcy procedures to conclude that a trade-off exists between ex post and ex ante efficiency. Cornelli and Felli do not explain why absolute priority violations should be an integral part of corporate bankruptcy settings. They do not connect absolute priority deviations to a problem of asymmetric information that appears in a corporate bankruptcy setting. They also differ in their consideration of a simultaneous change in the incentives of both senior and junior creditors to monitor, and suggest that erosion of the senior creditor's claim occurs as a result of lower returns to all creditors rather than as a result of a longer formal bankruptcy procedure.

317. See Note, *Switching Priorities*, *supra* note 297, at 2542-43.

318. *Id.* at 2554.

secured creditors have informational advantages over other parties such as shareholders and consumers in determining risk levels and discovering firm behavior.³¹⁹

This survey of literature suggests that secured creditors can perform certain tasks better than any other relevant agent. Secured creditors are particularly adept at monitoring the firm and reversing its fortunes. It is also thought that eroding secured creditors' full priority will improve efficiency. However, two problems remain unresolved. First, what is the precise goal to be accomplished by better positioned secured creditors? In particular, what is the exact purpose of requiring secured creditors to increase their monitoring activity during the time referred to as the "eve of bankruptcy?" Second, what are the exact terms that make the utilization of secured creditors efficient? For example, what is the precise mechanism by which secured creditors decide how much to invest in "monitoring" and how can problems of over-investment or under-investment in "monitoring" be addressed by lawmakers?

2. Defining a New Task for the Secured Creditor

A reasonable first step in the design of a scheme that purports to utilize secured creditors as superior decision-makers would be to clearly define their assigned tasks. As the idea has not been previously addressed, this section discusses the situations in which secured creditors should be expected to take action. Collecting information about the firm and its operations is most likely their central task because of its potential usefulness in a formal bankruptcy procedure. It is thus suggested that prior to the initiation of a formal bankruptcy procedure, a secured creditor should be considered a better positioned agent because of his advantage over other agents in monitoring the firm over relatively long periods of time. He may also pressure the firm to take action, which reduces the length of a future formal bankruptcy procedure.³²⁰ Thus, the secured creditor can either monitor the firm and collect relevant financial data—its assets and operations, possible redeployment options of its assets, etc.—or alternatively, he may push the firm into a turnaround effort sooner than would have otherwise been possible. For example, a dominant secured

319. *Id.* at 2555.

320. This assumption regarding the secured creditor's capabilities will be tested in Part IV.C.2. Indeed, a different assumption (rendering the Better Positioned Agent approach ineffective) could be that the secured creditor is not, in all possible circumstances, a better positioned agent relative to others. However, it seems that one arguing the latter assumption, rather than the former, would have to back his argument with convincing empirical findings, as life experience and common sense indicate that the secured creditor (at least occasionally) is indeed better positioned relative to other agents, *as far as performance of a certain designated task is considered*.

creditor can pressure the firm to arrange for some form of a workout that would considerably shorten the length of any subsequent formal bankruptcy procedure.

The latter trait attributed to the secured creditor becomes critical when one recognizes that the timing of the firm's entrance into a formal bankruptcy procedure is highly endogenous. Indeed, firms often hide their financial difficulties from outsiders.³²¹ For example, financially-distressed firms commonly cut projects in order to free cash flows to finance losses. Also, changes in accounting practices are often adopted to generate additional "income." The firm's insiders—its managers and owners—usually have strong incentives to hide the firm's state of financial distress and to avoid a formal bankruptcy procedure.³²² On other occasions, firms—especially small- and medium-sized firms—may adopt an escapism mentality; however, the seriousness of the firm's financial difficulties should not be ignored.³²³ Accordingly, the secured creditor faces a relevant redeployment decision prior to the commencement of any formal bankruptcy procedure. Pushing the firm into a turnaround activity sooner—when sooner is better than a late attempt to salvage leftovers—means that the secured creditor can bring about a redeployment of the assets.

The BPA surplus created by a better-positioned secured creditor corresponds to their performance of two tasks. First, the secured creditor can reduce the efficiency costs attributed to the misallocation of the firm's assets during the period in which the financially-distressed firm is in a long and wasteful formal bankruptcy procedure; this period is when the appropriate redeployment decision is being contemplated by decision-makers. For example, financially-distressed firms spend a considerable amount of time in a formal bankruptcy proceeding while the bankruptcy court obtains relevant information about the firm and explores alternative redeployment paths. Second, the BPA surplus created by a better positioned secured creditor can also include efficiency costs attributed to

321. Povel, *supra* note 80, at 659.

322. *Id.* at 660.

323. Practitioners whose expertise is reorganization of bankrupt construction companies argue that, in most cases, owners of small- and medium-sized construction companies seek professional help too late. Had they sought assistance six months earlier, when their firm began to experience financial difficulties, the result might have been completely different and perhaps insolvency could have been avoided. Amir Helmer, *How To Reorganize a Failed Construction Company*, THE MARKER [an economic newspaper in Hebrew resembling the *Wall St. Journal*] Nov. 10, 2004 (quoting Amir Bartov, Adv., and Haim Kamil, CPA, two practitioners who specialize in reorganization of bankrupt construction companies, arguing that in most cases owners of small- and medium-sized construction companies seek professional help too late, and had they reached out six months earlier, as their firms begin to experience financial difficulties, the result might have been utterly different, and perhaps insolvency would not have occurred).

the misallocation of the firm's assets during the period before the firm enters a formal bankruptcy procedure. This can also be reduced by the secured creditor.

It is important to note that the new task of the secured creditor does not necessitate an assumption of excessive responsibility. In contrast to what some commentators seem to expect, the secured creditor should not decide whether the firm should be liquidated or reorganized; rather, the secured creditor is expected to minimize the time required to conduct a formal bankruptcy procedure, during which time necessary information about the firm is acquired and alternative ways to cope with its financial crisis are explored. In summary, instead of having a bankruptcy judge or a trustee gather information—which often comes from interested parties—and examine alternative redeployment paths for the firm's assets—which is done under the straining conditions of a formal bankruptcy procedure—it is suggested that a secured creditor be induced to assume these functions and subsequently shorten the formal bankruptcy procedure.

The new task defined here is the first parameter on which corporate bankruptcy procedures are evaluated. Recall that the redeployment mechanism employed by any corporate bankruptcy system can be assessed with regard to its costs and the quality of its decisions. The new task for the secured creditor defined here addresses the costs parameter, as a shorter redeployment process—a shorter formal bankruptcy procedure—reduces the costs of a redeployment mechanism. It is possible, however, that the quality of decisions generated when the secured creditor performs this designated new task is also improved. For example, if one assumes that secured creditors can access information about the firm that is not accessible to others, then inducing the secured creditor to gather information would improve the quality of decisions resulting from the redeployment mechanism.

C. Impediments to Employing the Secured Creditor as a Better Positioned Agent

Making the assumption that secured creditors are better positioned to accomplish a designated task prior to the commencement of a formal bankruptcy procedure is only the beginning. Indeed, several obstacles stand in the way of any attempt to utilize secured creditors as better positioned agents in this situation. These impediments will now be analyzed in detail.

1. Asymmetric Information

a. *The problem*

Any financial relationship where one party lacks the necessary information and control relative to the other party demonstrates the problem of asymmetric information.³²⁴ To be sure, the uninformed agent does not know if the relevant characteristics of the informed agent are good or bad. Absent a means for the uninformed agent to distinguish the quality of the informed agent, he will tend to pay the equilibrium price, which is the average price paid for the services of agents of varying qualities. This is a pooling equilibrium, which imposes a cost on informed agents of good quality. The problem of asymmetric information can take several forms,³²⁵ but conventional wisdom considers private information to be an impediment to efficiency.³²⁶

The Better Positioned Agent approach—at least in the context of the dominant secured creditor discussed here—cannot be implemented without the social planner resolving a problem of private information.³²⁷ The BPA approach assumes the possible existence of better positioned agents in several of bankruptcy's decision-making contexts. Rather than leave unresolved the question of who is to be considered a BPA at any point in time during bankruptcy, a new approach is suggested in which lawmakers presume that certain agents, in this case the abovementioned secured creditor, may in fact possess the ability to create a BPA surplus and increase claimants' wealth.

324. See generally George A. Akerlof, *The Market For "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (discussing how the quality of goods and uncertainty affects the market); Ricardo N. Bebczuk, *ASYMMETRIC INFORMATION IN FINANCIAL MARKETS—INTRODUCTION AND APPLICATIONS* (2003) (discussing asymmetric information and its implications in both micro- and macroeconomic terms); Linda Schmid Klein, Thomas J. O'Brien & Stephen R. Peters, *Debt vs. Equity and Asymmetric Information: A Review*, 37 FIN. REV. 317 (2002) (reviewing information asymmetry and the choice of debt or equity).

325. See Bebczuk, *supra* note 324, at 7.

326. See, e.g., DOUGLAS G. BAIRD, ROBERT H. GERTNER, AND RANDAL C. PICKER, *GAME THEORY AND THE LAW* 269-71 (1995) (applying game-theoretic models to the study of law); ERIC RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* (4th ed., 2007) (discussing non-cooperative game theory and asymmetric information). See also Bruce C. Greenwald & Joseph E. Stiglitz, *Asymmetric Information and the New Theory of the Firm: Financial Constraints and Risk Behavior*, 80 AM. ECON. REV. 160 (1990) (examining the consequences of imperfect information on the behavior of firms).

327. Explaining the law in this way, as a solution to a problem of asymmetric information rather than as a solution to a problem of minimizing social costs, is superior as it can fit a contractual paradigm of bankruptcy law as well. Approaching the problem this way captures both ex post efficiency considerations and ex ante efficiency traits.

Nevertheless, even if certain agents are better positioned for the designated task, a problem still remains: when considering whether to apply the Better Positioned Agent approach with regard to the secured creditor of the firm—which expects the creditor to act before a formal bankruptcy procedure—the relevant liability decision is made *ex post*, as the BPA surplus should have been generated by the time the secured creditor's actions are reviewed. However, an *ex post* decision-maker, who must impose liability for misguided actions in the past, cannot ascertain the actions of a dominant secured creditor prior to the start of a formal bankruptcy proceeding. In other words, while the process of determining “BPA surplus” is highly variable, the owners of the firm's assets—its creditors—cannot receive information about the process from the dominant secured creditor.³²⁸

Thus, when a bankruptcy procedure begins, a social planner interested in utilizing secured creditors as BPAs to shorten the formal bankruptcy procedure has the problem of asymmetric information in his inability to distinguish between BPAs and non-BPAs. To be sure, it is impossible to distinguish between secured creditors who have produced a BPA surplus by the time the formal bankruptcy procedure commences, and those agents who have not. Note, that it is irrelevant why any particular agent did not produce a BPA surplus. It is possible that the secured creditor was unable to efficiently create a surplus, that a surplus could not be created at all, or that the secured creditor simply slacked off. The problem is that the social planner cannot distinguish between the two types of secured creditors, and therefore cannot assign sanctions or rewards based on whether they have generated a surplus.

As a result of this lack of reward or sanction, secured creditors do not make any BPA effort whatsoever. After all, if a “good” secured creditor is not being rewarded for being “good,” why should he exert an effort to be “good”? Thus, when all secured creditors face the same sanction, even secured creditors with BPA potential will exert no effort at all to produce the surplus. This situation arises in bankruptcy, where all types of secured creditors receive full priority. The problem reappears at the stage of the security contract formation; the inability to distinguish between BPAs and non-BPAs in bankruptcy means that secured creditors and firms, or more accurately secured creditors and other claimants of the firm, do not include the contingency of BPA surplus production in their negotiations.

Note that even applying the most severe sanction to all secured creditors when the firm enters a formal bankruptcy procedure cannot solve this problem of asymmetric information. The problem always lies in the

328. ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, *MICROECONOMIC THEORY* 445-46 (1995).

inability of agents to identify the secured creditor's type in bankruptcy. For example, consider the possibility that the BPA surplus to be generated by secured creditors consists only of the surplus generated when the length of the formal bankruptcy procedure is shortened, rather than of a value generated when the formal bankruptcy procedure is prevented altogether. In other words, assume—very realistically—that BPAs can only efficiently curtail the length of the bankruptcy procedure, but cannot prevent it. If all secured creditors are denied 100% of their priority in bankruptcy (or 20%, or 30%) then potential BPAs—secured creditors who can efficiently shorten the length of the formal bankruptcy—will avoid taking wealth-increasing actions. They will exert no BPA effort, and at the stage of contract formation, the market will comprise only non-BPAs.

b. A solution: Screening enabled by the law

How can a social planner help market participants overcome this informational asymmetry so that a successful BPA scheme is implemented? I argue that the law can assist in devising a market-response solution to the problem of asymmetric information.

The commencement of a formal bankruptcy procedure enables decisions to be made on agents' past performances. The bankruptcy process can thus be used to screen BPAs' past performances or allow BPAs to signal the value of future projects.³²⁹ This approach is a possible solution for the problem of asymmetric information that arises when utilizing secured creditors as BPAs. The difference between signaling and screening concerns the question of who moves first. In screening, uninformed agents move first to offer a menu of choices, and the informed agent selects the choice that yields the highest payoff. Within the menu of choices offered by the uninformed agents, a cost can be imposed in a manner that screens between different types of informed agents. Of course, designing choices that would enable the uninformed agents to distinguish between types of informed agents requires that each type of informed agent have an incentive to select the menu choice meant for him.

Recall that if the law did not intervene, the firm, or its claimants, would be unable to contract in advance with secured creditors to generate a BPA surplus, because claimants would not be able to review secured creditors' actions *ex post* to distinguish between those who have produced

329. See generally, Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371 (1977) (arguing that the willingness to invest signals value); Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393 (1984) (describing the role of the bankruptcy "penalty" in debt contracts). It is a costly signal, because at equilibrium a risk-averse BPA retains some "project specific risk" that would be avoided with full information.

a BPA surplus (BPAs), and those who have not (non-BPAs). Indeed, the secured creditor's type—based upon its past actions—cannot be verified. If inducing secured creditors to act³³⁰ requires a sanction to be imposed upon better positioned secured creditors who failed to act, then all secured creditors will argue before the bankruptcy court that they generated a BPA surplus in order to avoid the sanction. Of course, no one can verify either argument in order to distinguish between types of secured creditors. Imposing no sanction at all will result in secured creditors with BPA potential failing to act, and not incurring any penalty as a result. The third possibility of imposing sanctions on all secured creditors in bankruptcy proceedings fails, at the very least, to allow a BPA surplus to be generated from shortening a long formal bankruptcy procedure. All three of these solutions produce no BPA effort *ex post*, and a market of only non-BPAs *ex ante*.

Bankruptcy's inability to distinguish between types of secured creditors makes it less efficient. The social planner cannot create proper incentives for secured creditors who can efficiently avoid or shorten a formal bankruptcy procedure, and for secured creditors who cannot efficiently prevent a formal bankruptcy procedure, or curb its length. The social planner also cannot impose a sanction only on secured creditors who can efficiently avoid a formal bankruptcy procedure, but failed to do so. Therefore, BPA surplus cannot be the subject of negotiation in contracts between secured creditors and the firm.

To solve this problem of asymmetric information, bankruptcy law can intervene and offer secured creditors two choices:

- (1) When a BPA surplus exists, act in order to generate it: prior to the commencement of a formal bankruptcy procedure, the secured creditor should invest resources in monitoring the firm or inspiring a turnaround process within it, as that is when the secured creditor can efficiently do so in order to avoid or shorten a future formal bankruptcy procedure.
- (2) When a BPA surplus does not exist, do not act: the secured creditor need not invest resources in monitoring the firm, or in inspiring a turnaround process, when it is inefficient to do so in order to avoid or shorten a formal bankruptcy procedure.³³¹

Claimants of the firm would like, in advance, to be able to contract with secured creditors to generate a BPA surplus. The social planner would like secured creditors with BPA potential to adhere to choice (1),

330. Appropriate actions might include monitoring the firm or intervening in its day-to-day management.

331. In other words, secured creditors are forced to share the risks of a formal bankruptcy procedure, and therefore are induced to minimize those risks.

and secured creditors with no BPA potential to follow choice (2), for two reasons. First, from an *ex post* perspective, inducing secured creditors with no BPA potential to act is wasteful; if no surplus can be generated by such secured creditors, it is preferable that they sit and do nothing. Second, from an *ex ante* perspective, creating an incentive for secured creditors to act requires that their full priority be eroded; and since any erosion of secured creditors' full priority carries *ex ante* costs—for example, the price of credit becomes more costly for all agents in society—the social planner would like to minimize the *ex ante* costs of priority erosion by helping secured creditors escape the adverse effects of the formal bankruptcy procedure.

Consequently, in order to create a screening effect, the contract to be made available for secured creditors should be accompanied by a cost. Consider two possible methods of imposing such a cost: first, make the secured creditor give up a fixed percentage of his collateral if a formal bankruptcy procedure begins; and second, in the event of a formal bankruptcy procedure, deny the secured creditor his protections against collateral depreciation, both temporal and economic.

Imposing such a cost when secured creditors enter formal bankruptcy procedures would lead them to adopt one of two patterns of behavior:

- (1) Secured creditors with a potential to efficiently avoid a formal bankruptcy procedure as they are true BPAs, will invest resources in BPA activities—monitoring, for example—in order to escape the cost imposed by the law. For instance, assume that a secured creditor needs to invest a very small sum of money (\$100) in order to prevent a formal bankruptcy procedure.
- (2) Secured creditors with no potential to efficiently avoid a formal bankruptcy procedure as they are not BPAs, will not invest in BPA activities, nor prevent a formal bankruptcy procedure, and thus will incur the cost imposed by the law. For instance, assume that a secured creditor needs to invest an infinite sum of money in order to prevent a formal bankruptcy procedure.

Of course, making the secured creditor incur the cost imposed by the law during a formal bankruptcy procedure separates true BPAs from non-BPAs. Assume the cost imposed by the law is fixed at the amount \$1,000. A secured creditor corresponding to the description in behavior pattern (1) will choose to invest the little sum of money (\$100) in order to prevent a formal bankruptcy procedure and escape the fine of \$1,000. A secured creditor corresponding to the description in behavior pattern (2) will choose not to invest the infinite sum of money (which is higher than \$1,000) in order to avoid a formal bankruptcy procedure. He will prefer to incur the

cost of \$1,000. The screening effect separates true BPAs from non-BPAs by creating an appropriate incentive for each secured creditor to self-select and follow their appropriate pattern of behavior. If a certain secured creditor can efficiently invest in monitoring in order to avoid a formal bankruptcy procedure and avoid financial sanction, he will do so. On the other hand, if the secured creditor cannot efficiently avoid a formal bankruptcy procedure, he will be forced to incur the sanction.

Understanding the need to screen types of secured creditors through appropriate financial sanctions is the key to improving efficiency. Indeed, the cost imposed by the law during a bankruptcy procedure influences whether the secured creditor chooses behavior (1) or (2). Since the purpose of imposing the cost is to screen between efficient secured creditor action and inefficient secured creditor action, the amount of the sanction needs to reflect the efficiency criterion. It cannot be—as been implied so far by commentators such as Professors Bebchuk and Fried—an arbitrary cost, such as a fixed percentage of the secured creditor's collateral.

Efficient monitoring by a secured creditor means investing resources in order to prevent greater harm. The greatest harm for secured creditors in a formal bankruptcy procedure is the depreciation of its collateral, both temporal and economic, that can occur for each passing day. Thus, efficient monitoring by the secured creditor would mean investing resources to prevent the collateral from further depreciation on each additional day. Note that awarding the secured creditor with anti-depreciation protection means that other claimants of the firm actually pay the amount of depreciation to the secured creditor. Notwithstanding the entire range of harms prevented as the formal bankruptcy procedure becomes shorter, curbing the length of the formal bankruptcy procedure and thereby saving this amount of money thus reveals itself as a direct improvement such that more collateral will be available to be distributed among the other claimants.

Thus, denying secured creditors protection against collateral depreciation during the formal bankruptcy procedure will set the correct sanction upon secured creditors, and screen between those secured creditors who can efficiently shorten the length of the formal bankruptcy procedure and those who cannot.

Consequently, the secured creditor should be forced to share the costs of a long and costly bankruptcy procedure. I suggest that the best way to screen secured creditors is to force them to incur any depreciation in collateral value, whether economic or temporal, during the formal bankruptcy procedure. The price charged to the secured creditor should directly depend on the length of time it takes the collective procedure to

exhaust the relevant inquiries: the longer the procedure, the higher the price charged.³³²

Note that we have come full circle. Once the social planner, or other claimants, is able to separate BPAs from non-BPAs during bankruptcy, the creation of a BPA surplus becomes a contingency that can be contracted in advance. A secured creditor not interested in investing effort to produce a BPA surplus must now notify the firm, or other claimants, of the former's desire to be "bad," in order to change the terms of the contract and abolish the term specifying that no protections are to be awarded to the secured creditor during a formal bankruptcy procedure. Such a requirement reveals the secured creditor's type as a non-BPA, and the price paid for the loan by the firm, or other claimants, can change accordingly.

The following two tables describe the relevant events along a reversed timeline and summarize the arguments relating to a secured creditor (SC) and his role as BPA. The first table describes the situation when the problem of asymmetric information is not addressed; the second, when bankruptcy law creates a screening method to resolve the asymmetric information.

332. A possible criticism would be that the Better Positioned Agent model is helpless to the extent that the costs incurred by society are higher than the prevention costs incurred by the secured creditor, but the latter costs outweigh those incurred by the secured creditor should he choose not to invest in preventative action. Screening this way fails to induce secured creditors with BPA potential to realize when the cost of monitoring is higher than the amount of expected collateral depreciation, but lower than the sum of all damages to society from not curbing the length of the formal bankruptcy procedure. In such a case, though inducing the secured creditor to invest in monitoring is efficient, the secured creditor will not act. Indeed, one could argue that a social planner should aspire to make the secured creditor internalize the full amount of costs incurred by society during a wasteful bankruptcy procedure, for the cheapest cost avoider scheme to work. Such a scheme is possible, however, as the social planner can increase the price charged from secured creditors for each additional day spent by the firm in a formal bankruptcy proceeding (by ΔX). For example, the secured creditor can be charged 0.12% for each additional day spent by the firm in a bankruptcy procedure. The new price can then be tested empirically to ascertain whether the measured increase in the price charged from the secured creditor has indeed brought a certain decrease in efficiency costs. Note, however, that reducing the secured creditor's full priority may be inefficient because of its ex ante implications on secured credit. See discussion *infra* Part IV.C.3.b.

With asymmetric information:

Time	Event	What Happens?	Result
2	A formal bankruptcy procedure begins	Full priority for SC	Ex post asymmetric information problem: inability to distinguish between BPAs and non-BPAs
			→ only non-BPAs exist
1	SC contemplates an investment in creating a BPA surplus (investing in monitoring in order to avoid a formal bankruptcy procedure)	Since all SCs are expected to receive the same full priority treatment in bankruptcy, SC does not invest in creating the BPA surplus	No SC generates BPA surplus, even if the SC has BPA potential
			→ only non-BPAs exist
0	Contract between SC and Firm is negotiated	Only one contract is offered—full priority in case of bankruptcy	Ex ante asymmetric information problem: inability to distinguish between BPAs and non-BPAs; the creation of a BPA surplus is not negotiated
			→ only non-BPAs exist

With a screening mechanism in place to resolve asymmetric information:

Time	Event	What Happens?	Result
2	A formal bankruptcy procedure begins	No protection in bankruptcy against economic or temporal depreciation of collateral	SC's full priority is eroded when the firm enters a formal bankruptcy procedure to the extent of the economic and temporal depreciation of the collateral
1	SC contemplates an investment in creating a BPA surplus (investing in monitoring in order to avoid a formal bankruptcy procedure)	SC with BPA potential is willing to invest a sum of money to avoid a formal bankruptcy procedure up to the sum of expected depreciation of the collateral during the future procedure; if the latter sum exceeds the former → SC will invest in monitoring; if the former sum exceeds the latter → SC will not invest in monitoring	SCs with BPA potential produce BPA surplus; SCs with no BPA potential, do not produce BPA surplus
			→ BPAs are separated from non-BPAs
0	Contract between SC and Firm is being negotiated	Two alternative contracts are negotiated: (1) contract with no protection against economic or temporal depreciation of collateral in bankruptcy; (2) contract promising full priority in bankruptcy (i.e., promising these protections)	Each SC is forced to choose between contract (1) or (2)
			→ SC's choice is priced accordingly by Firm, or Firm's other claimants

2. Do BPAs Really Exist?

A problem facing any attempt to implement the new approach is the assumption that there is a BPA surplus, or that a BPA even exists. When is this assumption valid?

Of course, at least partially, this is an empirical question. Only empirical research can actually verify the existence of BPAs in a given decision-making context described by the Model. Such research is beyond the scope of this article, but the following insights may prove useful for lawmakers considering this question.

In recent years, an increasing number of scholars have begun to hypothesize that secured creditors exert control over the assets of the firm, particularly at times during which the firm becomes financially distressed, regardless of whether a formal bankruptcy procedure occurs or not.³³³ Yet these models do not account for the costs of the bankruptcy proceedings, or for the potential role of a secured creditor in shortening the process. What is lacking is a theory that places the secured creditor's mission within a broader framework. The following discussion attempts just that.

From the outset, it should be noted that while a secured creditor can intervene early to help 'turn around' a firm in financial distress,³³⁴ it is worth asking whether the secured creditor can indeed be a BPA in this context. In other words, is the secured creditor best positioned to monitor the firm³³⁵ or best-positioned to intervene—i.e., pressure the firm to make organizational changes or restructure its capital—in order to minimize potential bankruptcy proceedings in the future?

333. See the review of literature, *supra*, in Part IV.B.1. See also Baird & Rasmussen, *Control Rights*, *supra* note 277, at 957-58 (advocating the secured creditor's ability to identify the existence of going concerns surplus in financially-distressed firms); Westbrook, *Control of Wealth*, *supra* note 276, at 806 (arguing that control is a key element of secured credit). A recent article examines whether secured creditors in certain cases are "well positioned" to make the firm stop its operations. However, that article takes a different approach from this one, as the secured creditor is considered as having a real option to bring about an auction of the firm's assets. See generally Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935 (2004). Although articulated in real option terms, the decision attributed to the secured creditor (including the awards for making a good decision) is altogether different than the one presented in this Article. For example, while Rasmussen's secured creditor needs to possess an ability to predict the firm's future in order to make a correct decision, the secured creditor in our essay needs only to identify current—rather than future—events, and possess a superior monitoring ability.

334. See, Povel, *supra* note 80, at 659-60 (weighing costs and benefits of delaying bankruptcy).

335. Monitoring the firm includes the gathering of information that would be useful on a day of reckoning when the firm enters a formal bankruptcy procedure.

a. *The monitoring task*

Consider first the monitoring task. For several reasons, secured creditors usually have a stronger incentive to monitor the borrowing firm than unsecured creditors do: first, because of the size of the loan extended by the secured creditor;³³⁶ second, because of the duration of the loan, which allows more opportunities for the borrowing firm to misbehave;³³⁷ and third, because at the relevant period of time—i.e., when the firm starts its deterioration into financial distress—the secured creditor may enjoy a comparative advantage over other creditors in monitoring a firm that is in financial distress.³³⁸ Note that such an advantage has been forged over time, and is certainly not obvious.³³⁹

Indeed, common sense supports a view espoused by the legal community and financial economists: certain secured creditors—banks in particular, but other financial institutions as well—undoubtedly possess superior ability to monitor the borrowing firm.³⁴⁰ These secured creditors

336. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1158 (1979) (arguing that creditors are expected to spend more on monitoring for larger loans).

337. See *id.* at 1159 (arguing that longer duration loans require more monitoring).

338. See, e.g., Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 53, 56 (1982) (providing examples where creditors have comparative advantage in monitoring).

339. The literature concerning the justifications for secured credit is used to assume that secured creditors are inferior monitors in comparison to trade creditors. See, e.g., Jackson & Kronman, *supra* note 336, at 1159-61 (explaining that different creditor types have different monitoring costs). However, as the authors themselves have implicitly indicated, the secured creditor's monitoring inferiority is relevant "before" any of the creditors agree to extend credit to the firm. *Id.* at 1160.

340. See, e.g., Anu Bharadwaj & Anil Shivdasani, *Valuation Effects of Bank Financing in Acquisitions*, 67 J. FIN. ECON. 113, 114 (2003) ("According to received theory, financial intermediaries (and banks in particular) serve as a bridge between firms and external capital markets due to their superior information collection and evaluation capabilities") (sources omitted); Arnoud W. A. Boot, *Relationship Banking: What Do We Know?*, 9 J. FIN. INTERMEDIATION 7, 7 (2000) ("[B]anks develop close relationships with borrowers over time. Such proximity between the bank and the borrower has been shown to facilitate monitoring and screening and can overcome problems of asymmetric information."); Oscar Couwenberg & Abe de Jong, *It Takes Two to Tango: An Empirical Tale of Distressed Firms and Assisting Banks*, 26 INT'L REV. L. & ECON. 429, 429-31 (2006) (studying the restructuring process of financially distressed small- and medium-sized firms in the Netherlands, which were assisted by their banks in the restructuring process, and concluding that banks appear to be informed about pre-distress indebtedness, and that a bank's involvement is "of crucial importance"); Sandeep Dahiya, Anthony Saunders & Anand Srinivasan, *Financial Distress and Bank Lending Relationships*, 58 J. FIN. 375, 376 (2003) ("[B]anks are considered insiders with significant informational advantages. This implies that banks are likely to be better informed about the financial status of their borrowers and thus will be able to take steps . . . before the news of a borrower's distress becomes public information."). For a list of relevant studies see Allen N. Berger & Gregory F. Udell,

are believed to be monitoring the firm on behalf of other investors.³⁴¹ Over time such institutions gain access to private information about their customers by cultivating relationships with them based on trust.³⁴² Banks, for example, gain access to firm-specific information unavailable to other creditors, including trade creditors and even the employees of the borrowing firm.³⁴³ One reason for the bank's unique position is the fact that bank debts are usually classified as "inside debt."³⁴⁴ For example, firms consider the bank to be an entity to which secret information ("proprietary information") can be safely conveyed, without worrying about leakage to competitors.³⁴⁵ Moreover, a borrowing firm may deliberately submit itself to monitoring by the bank in order to enhance the firm's reputation and gain credibility when it approaches other sources of financing, such as capital markets.³⁴⁶ Finally, banks are able to observe the firm from a relatively wide perspective, as they can gather information from the community in which the firm operates, and thereby gain insights into how the firm interacts with the local community.³⁴⁷ Banks tend to have specialized knowledge about the firm's industry sector, because they finance several other firms in that sector as well. They can therefore excel at monitoring decisions made by the firm, such as investment in new

Relationship Lending and Lines of Credit in Small Firm Finance, 68 J. BUS. 351, 352 (1995) and Soo-Wah Low et al., *The Link Between Bank Monitoring and Corporate Dividend Policy: The Case of Dividend Omissions*, 25 J. BANKING & FIN. 2069, 2071-72 (2001).

341. Diamond, *supra* note 329, at 393. For a list of studies, see Raghuram Rajan & Andrew Winton, *Covenants and Collateral as Incentives to Monitor*, 50 J. FIN. 1113 (1995).

342. Biagio Bossone, *Do Banks Have a Future? A Study on Banking and Finance as We Move into the Third Millennium*, 25 J. BANKING & FIN. 2239, 2242-43 (2001); Scott L. Lummer & John J. McConnell, *Further Evidence on the Bank Lending Process and the Capital-Market Response to Bank Loan Agreements*, 25 J. FIN. ECON. 99, 101, 121 (1989). For example, trust develops as the lender observes the bank as a steady and reliable source of funding, even at times of distress.

343. See Eugene F. Fama, *What's Different About Banks?*, 15 J. MONETARY ECON. 29, 36-38 (1985).

344. *Id.* at 36 (defining inside debt as a contract where the debt holder gets access to information not publicly available and may even participate in the firm's decision-making process).

345. Oved Yosha, *Information Disclosure Costs and the Choice of Financing Source*, 4 J. FIN. INTERMEDIATION 3, 4 (1995) (arguing that firms actually prefer the bank's "bilateral financing" over the capital market's "multilateral financing," and thus reject the capital market (rather than being rejected by the capital market)). See also Boot, *supra* note 340, at 10, 13.

346. Douglas W. Diamond, *Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt*, 99 J. POL. ECON. 689, 716 (1991).

347. Allen N. Berger, Leora F. Klapper & Gregory F. Udell, *The Ability of Banks to Lend to Informationally Opaque Small Businesses*, 25 J. BANKING & FIN. 2127, 2129-30 (2001).

projects.³⁴⁸ Banks also become specialized in techniques for extracting information directly from borrowers.³⁴⁹

Banks' unique monitoring position may result from the fact that they are suppliers of short-term finance. First, loan renewal processes serve as a mechanism that transmits information to the bank as the firm submits itself to periodic review.³⁵⁰ Consequently, when a bank extends an additional loan, not only does it gain access to new information, but it can also compare the firm's current situation with its earlier situation.³⁵¹ Any information obtained by the bank can also be used in multiple interactions with the same firm, since the bank's services are supplied repeatedly.³⁵² Second, short-term finance is the only commodity the firm can use in order to relieve itself from the pressure of other creditors.³⁵³ As a result, the firm is generally quite willing to share information with the bank in order to attain credit. Finally, monitoring collateral may give the bank valuable information over time.³⁵⁴ For example, when the collateral is listed in the firm's inventories or accounts receivable, the bank can extract intimate information about the firm merely by monitoring its collateral.³⁵⁵

The literature points to other reasons why secured creditors, especially banks, can become superior monitors. Banks are under pressure to monitor borrowing firms effectively because the banks can suffer damage if their clients suffer financial distress. The news of a firm's financial distress may be construed as a sign of poor banking skills, and a bank's reputation will be tarnished.³⁵⁶ This is not something to take lightly in an enterprise where the main activity is extending loans. Moreover, the state scrutinizes a bank's loaning activity to ensure that certain regulatory capital requirements are met. Such scrutiny is likely to increase when a borrower

348. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 100 (1985).

349. Bossone, *supra* note 342, at 2243.

350. Fama, *supra* note 343, at 36. The relevant assumption held by Fama is that certain bank loans usually stand last or close to last in the hierarchy of priority, thus triggering an evaluation of the firm's ability to meet low-priority claims.

351. *Id.* at 37-38.

352. Boot, *supra* note 340, at 10, 13.

353. See Hudson, *supra* note 306, at 51-52 (describing the view that banks are in a position to gather information about firm credit worthiness).

354. Randal C. Picker, *Secutiry Interests, Misbehavior and Common Pools*, 59 U. CHI. L. REV. 645 (1992).

355. Boot, *supra* note 340, at 15 n.14. See also Rajan & Winton, *supra* note 341, at 1114-16.

356. See Thomas J. Chemmanur & Paolo Fulghieri, *Reputation, Renegotiation, and the Choice between Bank Loans and Publicly Traded Debt*, 7 REV. FIN. STUD. 475, 476-77 (1994); Dahiya et al., *supra* note 340, at 376.

suffers financial distress, and this added oversight amounts to a “tax” on the bank’s activity.³⁵⁷

An interesting example of the possible benefits of close bank-firm relations can be found in Japan, where the phenomenon of Keiretsu prevails. Keiretsu, meaning “industrial group,” is a feature of Japanese industrial organization. The term describes a group of business enterprises based in different industries but connected to one another by ties of ownership, as well as by reliance on a large commercial bank as the major lender.³⁵⁸ The bank provides debt financing to each of these firms, owns some of their equity, and may even place bank executives in management positions. The relationship between the firm and the bank is such that the firm consults closely with the bank when considering new projects. Also, through regularly submitted performance reports, the bank is able to obtain information about the firm and its management that is otherwise unavailable.³⁵⁹ Notwithstanding the extensive criticism of the Keiretsu system and its economic implications,³⁶⁰ a recent study shows that, although financially-distressed firms affiliated with Keiretsu banks are more likely to be liquidated, there is no evidence to support a proposition that the Keiretsu arrangement induces mis-deployment of these firms’ assets—that is, there is no evidence suggesting mis-deployment in the form of excessive liquidation.³⁶¹ Moreover, this study indicates that, as it pertains to reorganizing firms, Keiretsu seems to be quite beneficial, as Keiretsu firms show a higher level of profitability than those outside.³⁶²

When evaluating these results with a focus on the monitoring aspect of the Keiretsu arrangement, it is important to recall that several scholars have argued that Keiretsu banks, armed with extensive information about the firm, actually engage in screening financially distressed firms to assess them for reorganization.³⁶³ Recall, however, that it has also been argued that after extended bank loans are secured, the bank no longer has an incentive to use its knowledge optimally, and that this results in firms that are kept alive too long.³⁶⁴ A similar problem results from the features of

357. Dahiya et al., *supra* note 340, at 376.

358. Stephen D. Prowse, *Institutional Investment Patterns and Corporate Financial Behavior in the United States and Japan*, 27 J. FIN. ECON. 43, 46 (1990).

359. Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORG. 399, 403 (1989).

360. *But see* Takeo Hoshi, Anil Kashyap & David Scharfstein, *The Role of Banks in Reducing the Costs of Financial Distress in Japan*, 27 J. FIN. ECON. 67, 86 (1990) (describing the positive effect of the Keiretsu system on financially-distressed firms).

361. Jean Helwege & Frank Packer, *Determinants of the Choice of Bankruptcy Procedure in Japan*, 12 J. FIN. INTERMEDIATION 96, 97 (2003).

362. *Id.*

363. Sheard, *supra* note 359, at 403. For a list of studies, see Helwege & Packer, *supra* note 361, at 102.

364. *See, e.g.,* Hudson, *supra* note 306, at 52.

relationship-banking described above.³⁶⁵ Still, it is the very intention of the BPA Model to create such an incentive.

b. The intervention task

Consider next the intervention task. The secured creditor's ability to intervene and pressure the firm to take measures to prevent bankruptcy has been acknowledged by scholars.³⁶⁶ Indeed, it has been argued that banks actually take advantage of their power over borrowers to advance a self-serving agenda. But the pressure applied by the bank can also be directed at inducing the firm to make necessary adjustments in its business activity—reorganization—or preparing for a restructuring of its capital. Anecdotal evidence supporting this ability of banks is ubiquitous.³⁶⁷ For example, a common practice among banks is to pressure deteriorating firms to hire professional consultants to assist the firm with improvement strategies.³⁶⁸ Empirical evidence supports other intervention practices, such

365. Boot, *supra* note 340, at 16 (describing the “soft budget constraint problem”).

366. See Bebchuk & Fried, *Uneasy Case*, *supra* note 11, at 903 (“[B]y virtue of its sophistication, resources, and leverage, the bank will be able to exert a significant amount of influence over the borrower. Indeed, a bank will frequently determine whether or not a borrower files for bankruptcy and the timing of any filing. Thus, the bank is in a unique position to control a borrower’s behavior.”) (internal citations omitted); Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1317-18, n.118 (describing reduction in monitoring); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 926-27 (1986) (describing leverage); Ivo Welch, *Why is Bank Debt Senior? A Theory of Asymmetry and Claim Priority Based on Influence Costs*, 10 REV. FIN. STUD. 1203, 1208-09 (1997) (advancing the theory that banks are better lobbyists and litigants).

367. Bank managers often say that firms usually do not become insolvent at once, and that there are always early signs to indicate the firm’s financial distress. These signs are detected by the credit-extending bank. Once a firm’s financial distress is recognized, the bank usually hires a professional to assist the firm and its managers in overcoming the problem. At other times—when the quiet treatment is insufficient or unsuitable for the particular firm—the bank considers a formal collective procedure for the firm. Welch, *supra* note 366, at 1208-09. One CPA, whose accounting firm practices “quiet management” of financially-distressed firms on behalf of lending banks, noted, “Once banks recognize a cash flow problem in a borrowing company, they ‘persuade’ its owners to accept our advice . . .” Rotem Shtarkman, *85% of Companies Inflate Their Owners Equity*, GLOBES [Israeli economic newspaper resembling the *Wall St. Journal*] Nov. 10, 2003 (reporting on an interview with Aliza Sharon, a CPA who specializes in advising firms in financial distress) (on file with author).

368. Sometimes these professionals are from within the bank itself. See Franks and Sussman, *supra* note 275, at 75 for a description of the special head-office unit—the “Business Support Unit” (“BSU”)—which conducts turnaround maneuvers for clients of each of the three examined commercial banks dominating the credit market for small- and medium-sized firms in Britain. The goal of the BSU is to “[send the firm] back to branch,” which conducted business with the firm before the firm became financially distressed. See also Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355,

as the supply of emergency financing.³⁶⁹ Moreover, it has been argued that for secured creditors, debt seniority may actually facilitate timely intervention because they can credibly threaten the firm.³⁷⁰ Note, in that regard, the influence wielded by a secured creditor depends on other factors. Creditors who are less specialized in monitoring or more dispersed, may be less effective at applying pressure on the firm. In fact, their smaller stakes often cause free-rider problems.³⁷¹ Moreover, empirical research reveals that, particularly with regard to small- and medium-sized firms, once a bank decides to place a firm in a formal bankruptcy proceeding, the court almost never contests the bank's decision.³⁷²

c. When will a secured creditor be a BPA?

When monitoring and intervening in a financially-distressed firm's affairs, secured creditors sometimes possess a comparative advantage not only over the firm's other creditors, but also over its owners. Managers of financially-distressed firms can be over-optimistic in their evaluation of the future of their firms; even when managers recognize a cash flow problem, they tend to convince themselves that it is merely temporary. Secondly, owners of financially-distressed firms often make self-serving decisions or even engage in fraudulent acts that threaten their firm's viability. Simply put, owners of small- and medium-sized companies may shamelessly leave their firms bankrupt.

The reforms suggested in this Article aim to help identify better positioned secured creditors and induce them to increase wealth. Theoretically these reforms can be implemented across the board; so in principle, lawmakers could apply them to all firms and all secured creditors. The screening mechanism will automatically sort all secured creditors according to their potential to increase wealth.

373-74 (1990) (discussing the possibility that bank lenders initiate senior management turnovers in financially distressed firms).

369. See Franks and Sussman, *supra* note 275, at 76, n.19 (recording a study of a rescue process that lasted on average 7.5 months, and resulted in a mean of 75% of the companies being turned around). See also Gilson, *supra* note 368, at 362 (indicating that bank lenders exercise significant influence over resource allocation in financially distressed firms). Finally, for evidence from the Keiretsu context, see Sheard, *supra* note 359, at 408.

370. See Boot, *supra* note 340, at 16 (explaining that without collateral, the borrower may anticipate that a bank's calling a loan due would have adverse effects on the bank as well, and thus not take such threats seriously. Such reaction would change once the collateral exists and the adverse affects over the bank are not anticipated). See also Gilson, *supra* note 368, at 365-68, (describing the use of restrictive covenants).

371. Boot, *supra* note 340, at 17.

372. Franks and Sussman, *supra* note 275, at 73 (examining a data set of 542 companies; the authors, surprisingly, found only one case in which the bank's action was challenged through litigation).

From a practical point of view, however, even if the screening solution described above would resolve the problem of identifying which particular secured creditor who has loaned money to the firm is in fact a BPA, one question remains: For what categories of cases should the screening solution be used? This question becomes relevant as the implementation of the BPA scheme, which requires an erosion of the secured creditor's full priority in bankruptcy, carries with it certain *ex ante* efficiency costs.³⁷³ As a result, lawmakers might be interested in a selective implementation of the BPA scheme described above, rather than an absolute, across-the-board implementation.

Selective implementation requires identifying those categories of firms for which the secured creditor will surely be able to generate a surplus, as well as differentiating the categories of firms for which the BPA scheme is less effective. A selective implementation also entails the identification of categories of secured creditors. Secured creditors with confirmed ability to generate a BPA surplus must also be distinguished from categories of secured creditors whose ability is yet unproven.

Consider first the types of borrowing firms. Indeed, the quest to articulate the secured creditor's mission as a better positioned agent must begin by assuming a particular prototypical model firm serves as a basis for analysis. I have noted that the typical firm for which the secured creditor can perform as a BPA is not a large, publicly traded company, but rather a small- to medium-sized firm, since such firms occupy most of the bankruptcy court's docket.³⁷⁴ For example, many closely-held firms have an institutional lender: in one study, about half of the firms surveyed had loans from financial institutions.³⁷⁵ Of these firms, roughly two-thirds have borrowed from a single institution.³⁷⁶ Over 90% of this borrowing was done on a secured basis.³⁷⁷ Literature has shown that the benefits of a close relationship between secured creditors and borrowing firms are likely to increase as the size of the firm decreases.³⁷⁸ This reflects not only the fact that smaller firms need to rely more on financial intermediaries such as banks instead of public debt,³⁷⁹ but that asymmetric information problems tend to be more severe in smaller firms. This means that the case for a

373. See *infra* Part IV.C.3.b.

374. See *supra* text accompanying note 275 (referring to Franks and Sussman's study of 542 small- to medium-sized financially distressed firms).

375. See Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. BANKING & FIN. 613, 636-38 (1998) (providing statistics regarding financial institution debt).

376. *Id.* at 638.

377. *Id.* at 637.

378. Boot, *supra* note 340, at 20.

379. Berger & Udell, *supra* note 340, at 351.

Better Positioned Agent model, in the context of the secured creditor—again, much like in analyses of the owner-shareholder context—is stronger where small- to medium-sized firms are concerned.

Consider next the types of secured creditors. The aforementioned comparative advantage enjoyed by secured creditors over other creditors does not necessarily derive from the mere existence of a collateral agreement involving the firm, but it can also be attributed to the simple fact that the secured creditor is a financial institution—the classic example being a bank. In reality, however, the existence of a secured claim generally coincides with the nature of the creditor as a financial institution. Of course, when implementing the BPA model in a specific jurisdiction, this assumption needs to be reexamined.

3. The Ex Ante—Ex Post Trade-Off

It is conventional wisdom in economic and financial theory that bankruptcy modification of pre-bankruptcy entitlements is prohibited unless such modification is necessary to accomplish better redeployment of the firm's assets.³⁸⁰ However, in order to accomplish the improved redeployment goal, the Better Positioned Agent approach clearly results in a serious adjustment of pre-bankruptcy entitlements. Importantly, the adjustment of pre-bankruptcy entitlements prescribed by the Better Positioned Agent approach includes intentional, and carefully guided, deviations from the absolute priority rule.

Bankruptcy scholars have recognized that the legal treatment of financially-distressed firms cannot be examined independent of the implications that the law carries for agents' behavior in "ex ante" time period.³⁸¹ From the perspective of bankruptcy law, the "ex ante" chapter in the firm's existence is distinguished from the "ex post" period of time, during which the firm becomes financially-distressed and legal intervention is considered. The phenomenon of deviations from the absolute priority rule has been examined in both the ex ante and ex post contexts. The ex ante/ex post distinction merits discussion in terms of the benefits and costs of both periods.

All explanations offered to rationalize absolute priority rule violations have assumed that these violations occur in a formal bankruptcy procedure that follows the Administrative Model-type procedure, e.g., the American

380. See, e.g., Baird & Jackson, *supra* note 14, at 104 ("Changes in nonbankruptcy rights should be made only if they benefit all those with interests in the firm as a group.").

381. See, e.g., Bebchuk, *Ex Ante Costs*, *supra* note 80; Rasmussen, *Ex Ante Effects*, *supra* note 1.

Chapter 11.³⁸² Although the Better Positioned Agent approach may coincide with a different type of corporate bankruptcy procedure, absolute priority rule violations induced by the Better Positioned Agent approach nevertheless require that all ex ante and ex post costs be evaluated.

Thus, implementing the Better Positioned Agent approach involves a trade-off that should draw the attention of lawmakers. The trade-off is a direct result of using the tool of bankruptcy redistribution to promote ex post efficiency. It is well established that bankruptcy redistribution, which is an ex post phenomenon, influences the ex ante decisions of investors as well as the ex ante decisions of other agents, such as managers.³⁸³ Therefore, the benefits and costs of ex post and ex ante periods are relevant.

a. Ex post effects

The Better Positioned Agent approach has beneficial ex post effects. The reasons for these beneficial effects are the subject of this Article and were discussed in the previous sections. The Better Positioned Agent approach has been suggested to directly improve the redeployment decision. In this context, other indirect positive effects on redeployment should be mentioned. Indeed, it has been argued that a particular absolute priority violation, towards shareholders, creates several positive ex post effects. The following effects are general rather than specific to a Chapter 11 procedure. First, the timing of filing for bankruptcy is improved because it creates an incentive for owners/shareholders to file for bankruptcy.³⁸⁴ Second, excessive risk taking during periods of financial-distress is discouraged because owners/managers do not fear bankruptcy as much.³⁸⁵ Third, underinvestment in financially-distressed firms is mitigated.³⁸⁶

382. Indeed, the American Chapter 11 was constantly compared to a procedure that does not usually bring about absolute priority rule violations, the British Receivership. The rules governing Receivership dictate an auction of the assets of the firm. See Bebchuk, *Ex Ante Costs*, *supra* note 80, at 446; *supra* text accompanying note 4 (describing what it means to restructure a firm's capital). See also Hansen & Thomas, *supra* note 158 (comparing procedures).

383. Hansen & Thomas, *supra* note 158, at 176-77.

384. Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223 (1991); Elazar Berkovitch & Ronen Israel, *The Bankruptcy Decision and Debt Contract Renegotiations*, 2 EUR. FIN. REV. 1 (1998) [hereinafter Berkovitch & Israel, *The Bankruptcy Decision*]; Berkovitch & Israel, *Optimal Bankruptcy*, *supra* note 162; Robert Heinkel & Josef Zechner, *Financial Distress and Optimal Capital Structure Adjustments*, 2 J. ECON. & MGMT. STRAT. 531 (1993); Povel, *supra* note 80. See also Hansen & Thomas, *supra* note 158, at 177 (discussing "the delay effect").

385. Allan C. Eberhart and Lemma W. Senbet, *Absolute Priority Rule Violations and Risk Incentives for Financially Distressed Firms*, 22 FIN. MGMT. 101 (1993); Gertner &

The ex post costs of corporate bankruptcy redistribution can also be immediately removed from the table. The redistributive benefits of the Better Positioned Agent approach seem to outweigh any ex post costs, such as those from forum shopping. This might occur once the firm experiences financial distress and pre-bankruptcy entitlements are expected to be altered by bankruptcy law. Otherwise, the bankruptcy intervention would be considered inefficient. However, this is not what happens in reality. Formal mandatory bankruptcy proceedings exist in almost every Western jurisdiction in the world. While the ex post costs resulting from the forum shopping problem may need to be minimized, the mere existence of the bankruptcy redistribution tool in many economies around the world is a strong indicator that the problem is rather small.

The Better Positioned Agent approach eliminates another possible source of ex post efficiency costs: a-priori costs. These are the costs of inefficient redeployment decisions made during the bankruptcy procedure because a whole new decision-making process is utilized instead of the processes dictated by the Administrative Model. For example, it has been argued that eroding the secured creditor's protections during an administrative-like bankruptcy procedure may bring about an inefficient redeployment of the assets of the firm as junior claimants, unsecured creditors and shareholders would choose to delay a final redeployment decision that would wipe out their claims, preferring an unjustified reorganization to a justified liquidation.³⁸⁷ Recall that the Better Positioned Agent approach requires a different redeployment mechanism from the law during a formal bankruptcy procedure. Thus, the junior claimants do not decide the fate of the firm's assets, and hence this source of ex post inefficiency is abolished.

Finally, when considering possible ex post costs of the Better Positioned Agent approach, the specific attempt to utilize the secured creditor as a BPA may raise concerns. One might argue that the secured creditor may respond to possible erosion of his protections in an expected bankruptcy proceeding by prematurely liquidating the firm, outside formal bankruptcy, either secretly or consensually.³⁸⁸ However, the secured

Scharfstein, *supra* note 123. See also Hansen & Thomas, *supra* note 158, at 177 (discussing "the gambling effect").

386. Berkovitch & Israel, *The Bankruptcy Decision*, *supra* note 384; Gertner & Scharfstein, *supra* note 123; M. White, *Corporate Bankruptcy*, *supra* note 119.

387. Baird & Jackson, *supra* note 14, at 121-25.

388. Cf., Lynn M. LoPucki, *Should the Secured Credit Carve Out Apply Only in Bankruptcy? A Systems/Strategic Analysis*, 82 CORNELL L. REV. 1483, 1489, 1498-1503 (1997) (determining that "either of two strategies would enable secured creditors to defeat the bankruptcy-only carve out under consideration;" and concluding "that a bankruptcy-only carve out would not change significantly the asset distributions of collapsing debtors or lending practices.").

creditor's ability to effectuate an inefficient liquidation in this manner is quite limited. First, liquidation may be impossible or costly for the secured creditor as asset sales may be limited, for example, by industry factors.³⁸⁹ Indeed, it has been argued that secured creditors are very reluctant to pursue liquidation of the collateral.³⁹⁰ Second, and more importantly, since an attempt by the secured creditor to prematurely liquidate the firm is "noisy," in the sense that it either alerts owners of the firm or unsecured creditors,³⁹¹ any attempt made by the secured creditor to privately—and inefficiently—liquidate the firm would result in an immediate filing of a bankruptcy petition. Filing for bankruptcy under these circumstances results in a long waiting period during which the fate and potential of the firm are sorted out, along with a stay of the secured creditor's right to foreclose on the collateral. During this interim period, the secured creditor does not enjoy any protections and he bears the risks of collateral depreciation. Because premature liquidations are quite "noisy," and since such noise threatens secured creditors with costly bankruptcy procedures, secured creditors are expected to avoid them.

Another expected response by the secured creditor is a demand that the firm holds collateral equal to more than 100% of the debt. In other words, secured creditors might insist on borrowers maintaining an equity cushion in the collateral, in a manner sufficient to remove any danger resulting from depreciation of the collateral. However, even this form of strategic behavior does not pose a threat. First, insisting on an equity cushion might not insulate the secured creditor from certain unexpected events that would physically depreciate the collateral and, with it, the secured claim. Second, a possible response that would easily overcome such strategic behavior by the secured creditor would be to allow the firm, at the beginning of the bankruptcy procedure, to expropriate any such equity cushion and use it as free collateral to obtain additional financing.³⁹² Third, the strategy of over-securing the loan cannot overcome the problem

389. See Paul Asquith, Robert Gertner & David Scharfstein, *Anatomy of Financial Distress: An Examination of Junk-Bond Issuers*, 109 QUAT. J. ECON. 625, 626-27 (1994).

390. Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 164 (1997) (studying three cases and noting that "a consistent belief by loan officers that a decision to repossess collateral and liquidate was tantamount to accepting a loss on the loan. Those officers generally believed that they could not hope to liquidate collateral at a value that would be sufficient to pay off the nominal loan balance and, more importantly, to cover the costs of repossession and liquidation, including the risks of litigation associated with any adversarial response.").

391. It is important to note that the law of preferences actually extends the period of time during which interested parties, such as unsecured creditors, can be alerted and retroactively turn around an inefficient liquidation up to a period of several months (usually three months). See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1342 (suggesting ways to increase the "noise" made by such premature liquidations).

392. Cf., e.g., J. White, *Death*, *supra* note 15, at 146.

of the temporal depreciation of the collateral. Indeed, lawmakers could easily dictate that no interest be paid to the secured creditor for the time of the formal bankruptcy procedure and that the secured creditor cannot avoid such a sanction or insulate themselves from this risk.

Ex post obstacles, therefore, would probably not impose significant costs, and the Better Positioned Agent approach would increase overall ex post efficiency. It is only upon consideration of the ex ante costs and benefits of violating the absolute priority rules, as induced under the terms of the Better Positioned Agent approach, that the plot thickens. Indeed, the ex ante benefits incurred by implementing the Better Positioned Agent approach must be weighed against the ex ante costs generated by it. Moreover, it should be noted that from the perspective of bankruptcy theory, ex ante costs, or benefits, are expected to be incurred by all firms in the economy, not only those in a state of financial distress. This is in contrast to the behavior of ex post costs and benefits.

What precise ex ante effects, both positive and negative, are expected to result from implementation of the Better Positioned Agent? The following discussion attempts to answer this difficult question.³⁹³

b. Ex ante effects

Consider the case of the eroding protections enjoyed by secured creditors against economic (physical) and financial (temporal) depreciation of the collateral during attempts to reorganize the firm. Recall that the Better Positioned Agent approach holds in such a case, as lawmakers are encouraged by the terms of the model to consider denial of these protections to the secured creditors. Denying secured creditors their protections against economic and financial depreciation of collateral is equivalent to applying a regime of partial priority for secured claims instead of a full priority regime.³⁹⁴ Indeed, during a bankruptcy procedure, these protections guarantee the integrity of the specific collateral in two dimensions: the physical and temporal dimensions. To the extent that such erosion is rendered efficient, from an ex post perspective, by the Better Positioned Agent model, the question remains: Can we endure the ex ante, economy-wide ramifications of eroding the secured creditor's protections?

393. Cf., Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1206 (noting the problem in attempting to characterize the ex ante effects of different bankruptcy reform proposals). See generally Barry E. Adler & George G. Triantis, *The Aftermath of North LaSalle Street*, 70 U. CIN. L. REV. 1225, 1235 (2002) ("The weighing of the positive and negative *ex ante* incentive effects of deviations from absolute priority is complex and we do not know of any sustained theoretical or empirical attempt to specify the conditions under which the prospect of deviation in bankruptcy optimizes incentives on balance.").

394. Bebchuk & Fried, *Uneasy Case*, *supra* note 11, at 911-13.

Scholars have argued, although for quite different reasons than those advocated here,³⁹⁵ that provision of full priority to secured creditors, rather than partial priority, may be inefficient, particularly when considering the ex ante costs of a full priority regime.³⁹⁶ First, decisions by borrowers with regard to potential tort liability are distorted under a full priority regime.³⁹⁷ In the presence of full priority to secured creditors' claims, and as a precaution to improve their products' safety, borrowers will invest even less than is possible under a partial priority regime. Indeed, better protection is given to the secured creditor's claim in the form of full priority with a lower interest rate charged by the borrower, and vice versa. Limiting the secured creditor to less than full priority of his claim activates the interest rate charged on the loan to induce borrowers to consider the scope of tort liability that is incurred, because such liability under the partial priority regime dilutes the secured creditor's claim.³⁹⁸ Second, full priority reduces the secured creditor's incentive to incorporate efficient covenants into the loan contract.³⁹⁹ Third, the full priority regime may encourage loan transactions that enable borrowers to fund inefficient projects.⁴⁰⁰ Making use of a security interest when some of the other creditors of the firm are "non-adjusting,"⁴⁰¹ creates a value transfer in bankruptcy from the non-adjusting creditors to the secured creditor. This value transfer subsidizes the transaction for the secured creditor and the borrower.⁴⁰² Finally, and most importantly, under a full priority regime, the secured creditor's incentive to monitor the firm and control the commencement time of a bankruptcy is not efficiently reduced.⁴⁰³

395. So far, proposals in literature to replace full priority for secured creditors' claims with partial priority have focused on the ex ante effects of such a change, and ignored the ex post benefits of such a change during a formal bankruptcy (provided it is implemented correctly). For a list of studies discussing secured credit priority alterations in the bankruptcy context, see Julia Patterson Forrester, *Bankruptcy Takings*, 51 FLA. L. REV. 851, 852-53, n.5, 862-63 (1999).

396. See Bebchuk & Fried, *Uneasy Case*, *supra* note 11, at 898-903; Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1314-21. Note that only priority-dependent efficiency costs are considered here, and that priority-independent costs are not considered.

397. See Bebchuk & Fried, *Uneasy Case*, *supra* note 11, at 898-900 ("The first priority-dependent efficiency cost of security interests is that their use under full priority may distort a borrower's choice of investments and level of precaution.").

398. For a different view, and the responses to it, see Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1319-20.

399. Bebchuk & Fried, *Uneasy Case*, *supra* note 11, at 900-02.

400. Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1320-21.

401. For the definition of "non-adjusting creditors," see *supra* note 12.

402. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1293-94 (arguing that the value transfer acts as a subsidy for the use of a security interest by reducing the apparent cost to the borrower and the secured creditor).

403. *Id.* at 1315-18. This conclusion is not without its doubters, as the literature is split on the issue. See the discussion in Bebchuk & Fried, *Uneasy Case*, *supra* note 11, at 913-17.

Of course, a partial priority regime may be costly, as it carries with it the danger that the firm may not receive adequate financing from secured creditors in the first place.⁴⁰⁴ For example, it has been argued that, absent full priority, some lenders may be unwilling to lend money to borrowers, even at a high interest rate.⁴⁰⁵ However, scholars are still very much divided on the question of the partial priority regime's effect on the cost and availability of credit.⁴⁰⁶ For example, it has been argued that the aggregate cost of credit in the economy may be lower under a partial priority regime, as voluntary unsecured creditors would reduce the interest rate that they charge to reflect the lower risk that they face.⁴⁰⁷ It thus seems that only extensive empirical research—which is far beyond the scope of this Article—can resolve the debate.

Other possible ex ante costs may emerge from an increase in the level of monitoring exerted by secured creditors. For example, it has been argued that the relationship between a firm with a monitoring bank creates a trade-off between reduced agency costs associated with lending to small- and medium-sized firms and distortions in such firm's owner's incentives to exert effort.⁴⁰⁸ In other words, a secured creditor that is excessively involved in the day-to-day management of the firm can discourage efficient management decisions. Again, this is an issue that can only be resolved with empirical research.

It is therefore possible that the abrasion of the secured creditor's full priority in bankruptcy is efficient. Still, considering the ex ante effects of the Better Positioned Agent approach against this background raises two

However, it seems that scholars are more inclined to conclude that monitoring behavior is not efficiently reduced. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1315 n.109 (reporting the conventional wisdom in a symposium held on the full vs. partial priority: "During the Symposium, no one expressed support for full priority on these grounds . . .").

404. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1328-36 for a discussion and a list of critics of the partial priority concept.

405. See, e.g., Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2036-37 (1994).

406. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1329 (arguing that "on an aggregate basis, the availability and cost of credit need not change substantially under a rule of partial priority").

407. See *id.* at 1331-32 (presenting different arguments for how a partial priority rule could either "increase or decrease the aggregate cost of credit in the economy").

408. See, e.g., Raghuram G. Rajan, *Insiders and Outsiders: The Choice Between Informed and Arm's-Length Debt*, 47 J. FIN. 1367, 1368 (1992) ("An informed bank will be able to control an owner's decision such that the project is continued only if it has a positive NPV. In the process of doing so, however, it adversely affects the owner's incentive to exert effort.")

questions.⁴⁰⁹ First, what is the optimal way to deny secured creditors the full priority of their claims? Will denial of anti-depreciation protections to secured creditors, rather than application of other strategies that result in partial priority, create a problem? Second, should the secured creditor be denied only its bankruptcy protection against financial depreciation, only of its bankruptcy protection against economic depreciation, or both?

Professors Bebchuk and Fried have suggested two prototypical partial priority rules to replace the conventional full priority rule.⁴¹⁰ The “fixed-fraction priority rule” dictates that a pre-determined fixed fraction of the collateral backing a secured claim—for example, 25%—would be made available to pay the claims of the unsecured debt. An “adjustable-priority” rule orders that secured claims be afforded priority only over claims of certain creditors, including “non-adjusting creditors” or creditors who have explicitly agreed to be subordinated.⁴¹¹ The Better Positioned Agent model introduces a third prototypical partial priority rule for bankruptcy procedures: a “self-dependent priority rule.” According to the “self-dependent priority rule,” the extent to which a secured claim is afforded full priority depends upon the actions of the secured creditor. In fact, the secured creditor can maneuver in such a way that his full priority status either survives the bankruptcy procedure or is significantly eroded. Thus, the secured creditor can “decide” whether his claim is afforded full priority if a bankruptcy proceeding commences or whether his claim’s full priority status is to be eroded.

It is reasonable to assume that a partial priority regime resorting to the self-dependent priority rule is likely to increase the ex ante efforts that secured creditors invest in sorting borrowers. Indeed, under a self-dependent partial priority regime, secured creditors realize that a full priority outcome is obtainable and that achieving this outcome depends on the secured creditor’s ex post efforts to monitor the borrowing firm and induce action when necessary, and on the secured creditor’s ex ante efforts

409. One additional question has already been answered by the Better Positioned Agent model: should the denial of full priority be restricted to formal bankruptcy proceedings only, or apply also in cases where a collective procedure is not initiated at all and the secured creditor is exercising his rights in an individual collection procedure? The Better Positioned Agent model applies in formal bankruptcy proceedings only and is thus uninterested in what happens outside of bankruptcy.

410. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1321 (explaining the fixed-fraction and adjustable priority rules). A third rule, a consensual priority rule, would give a secured creditor priority in the collateral only over the claims of consenting creditors. See *id.* at 1327. This third rule does not solve the problem which is addressed here—of asymmetric information—and as a matter of convenience will be ignored.

411. Note that the rules offered by Professors Bebchuk and Fried dictate that secured creditor claims receive at least as much as unsecured creditor claims. In other words, these rules are not subordination rules. See Bebchuk & Fried, *Further Thoughts*, *supra* note 11, at 1322.

to properly sort his borrowers. “Good” borrowers would be expected to either completely avoid bankruptcy or enable the secured creditor to effectively monitor their business in preparation for incidents of financial distress. These borrowers may also apply pressure to induce a timely workout or a pre-packaged bankruptcy, or accurately time the commencement of a formal bankruptcy proceeding. The *ex ante* result is expected to be beneficial, as “good” borrowers would be distinguished from “bad” borrowers, and financing would be extended only to “good” borrowers.

Finally, consider the question of which protection should be eroded during bankruptcy—the protection against temporal depreciation of the collateral and/or the protection against physical depreciation of the collateral. To the extent that the self-dependent priority rule aims to induce secured creditor action by threatening the secured creditor with partial priority over unsecured creditors, there seems to be a reason to deny both protections. They represent the value of the collateral in two different dimensions: the physical dimension, in which the required protection is against economic depreciation of the collateral, and the temporal dimension, in which the required protection is against financial depreciation of the collateral.

In conclusion, the Better Positioned Agent approach would probably not incur high *ex post* or *ex ante* costs. The new approach’s non-systematic tendency to deviate from the absolute priority rule contributes to the *ex ante* overall positive result. However, in light of the identified *ex ante* costs, which need to be added to the *ex post* costs, the question to be posed to policymakers should be one of magnitude and scope: which effect of absolute priority violations is stronger—the negative or the positive?⁴¹² Only empirical data can answer this question without casting doubt.⁴¹³

D. The Normative Argument

The preceding sections have put forward a new approach according to which decision-making mechanisms in corporate bankruptcy settings ought to be crafted with the goal of increasing efficiency. What should lawmakers do in order to implement the Better Positioned Agent approach, as far as the dominant secured creditor of a small- to medium-sized firm is concerned?

412. Bebchuk, *Ex Ante Costs*, *supra* note 80, at 457.

413. For example, consider Professor’s Bebchuk’s argument: “One causal observation that is consistent with the view that [absolute priority] is overall desirable is that, in countries like the United Kingdom in which insolvency law does not produce significant deviations from [absolute priority], parties do not generally provide for such deviations in their contracts.” *See id.*

Secured creditors should be considered better positioned agents. However, the Administrative Model—the basis of bankruptcy regimes around the world—and the Residual Owner reform proposals do not include instructions for deliberate erosion of secured creditors' protections or full priority. On the contrary, two doctrines—the doctrine of adequate protection and the doctrine of post-petition interest, for over-secured creditors⁴¹⁴—have always been considered to be central to any reorganization attempt. They require that assets held as collateral by secured creditors be available to the firm for its success. Thus, except for sporadic and unintentional erosion of secured creditors' protections, secured creditors have enjoyed their full entitlements during formal bankruptcy proceedings. Unfortunately, in doing so legal systems have not taken advantage of the opportunity to utilize these secured creditors as the cheapest cost avoiders.

The Better Positioned Agent approach recommends that the doctrine of adequate protection and the doctrine of post-petition interest be abrogated whenever lawmakers identify dominant and influential secured creditors. Alerting such secured creditors to the cost of delays during a formal bankruptcy procedure that prohibits them from exercising their entitlement to foreclose on the collateral will subsequently induce them to work in advance in order to curtail any expected delay period. Moreover, in addition to improving redeployment prior to the commencement of a formal bankruptcy procedure, the new reform proposed here would also greatly simplify the complicated process of ensuring that secured creditors are adequately protected. Most importantly, the new reform renders the valuation of the collateral in order to appreciate its value—and the value to be adequately protected—unnecessary.

Thus, any additional protection derived from the adequate protection doctrine should be abolished as well. For example, American bankruptcy law dictates that where adequate protection proves *ex post facto* to be inadequate, the secured creditor has a right to treat the resulting loss as an administrative expense, with super-priority status.⁴¹⁵ Adopting the Better Positioned Agent approach in the secured creditor's context should lead lawmakers to reject such protection.

Moreover, should future empirical data reveal that eliminating adequate protection and post-petition interest is an insufficient means of inducing better positioned secured creditors to act as cheapest cost avoiders, an additional restriction of their bankruptcy entitlements would have to be considered. Lawmakers would have to consider further changes to the full priority of the secured creditors regime into a partial priority

414. *See supra* notes 14-16.

415. *See* 11 U.S.C. § 507(b) (2000 & Supp. V 2005).

regime that applies a self-dependent priority rule but this time increases the "price" collected from secured creditors for each additional time unit spent by the firm in a formal bankruptcy proceeding.

Still, a question arises concerning the possible costs of applying the proposed reform, as the new reform requires that two seemingly important doctrines be abolished: the adequate protection doctrine and the doctrine of post-petition interest for secured creditors. Two rationales are conventionally considered to support these doctrines. First, secured creditors are perceived to be entitled to protection of their property rights in the collateral. Second, the requirement to extend secured creditors adequate protection and post-petition interest on their secured claim has been considered to engender a screening device, which enables elimination of inefficient reorganization attempts. This device comes into action once a new supplier of finance arrives, usually when the firm enters a formal bankruptcy procedure, and conditions that the extension of new credit to the firm already in a formal reorganization procedure be backed with a security interest in the assets of the firm. Indeed, it is not easy to persuade someone to lend money to a financially-distressed firm, let alone a firm in a formal bankruptcy procedure. However, requiring that new finance be extended subject to the secured creditor being afforded adequate protection and post-petition interest, in a manner that enables new suppliers of finance to effectively enjoy a security interest only in the surplus to exceed the secured creditors' share, brings about the result that only value-enhancing reorganizations are facilitated.

The two rationales are thus future facing. They seem to contradict the rationale derived from the Better Positioned Agent approach, which hopes to improve the decision-making process that precedes the initiation of a formal bankruptcy procedure. While the first rationale to support protections for secured creditors against physical and financial depreciation of their secured claim is deontological and thus irrelevant for the current efficiency investigation, the second rationale raises a query regarding the inefficiency of denying secured creditors their protections. Will application of the Better Positioned Agent approach, and denial of the adequate protection and post-petition interest of the better positioned secured creditors, sacrifice the screening mechanism described above?

The answer is no. Application of the Better Positioned Agent approach in the context of the secured creditor, which aims to improve decision-making prior to the commencement of a formal bankruptcy procedure, does not need to come at the expense of making efficient decisions during the formal procedure. Indeed, the above-mentioned screening mechanism is associated with administrative bankruptcy decision-making. Replacing the administrative procedure with a different bankruptcy decision-making mechanism—a reform advocated by

proponents of the Residual Owner Model—would render the adequate protection and post-petition interest doctrines irrelevant for the purpose of screening efficient reorganizations. Even in a setting that follows, more or less, the contours of the Administrative Model, the new reform does not necessarily hinder the screening effect attributed to the adequate protection and post-petition interest doctrines.

Consider an example: As soon as a formal bankruptcy procedure commences, the firm—holding a debt load of \$200, \$150 of which is a secured claim—is auctioned. The auction serves to create a benchmark valuation of the firm's assets. The highest bid in the auction stands on \$160. A new supplier of finance, joining those who argue that the firm ought to be given breathing space for six months in order to explore its true potential, is asked to back up his request with a loan to the firm in the sum of \$15, which would keep the firm alive for the coming six months. In exchange, the new finance supplier's resulting claim against the firm would be ranked in the order of priorities for distribution behind claims at the total amount of \$160. In other words, the new supplier of finance would be ranked after claims at the amount of \$160, and before other claims at the amount of \$40. Of course, without subjecting the entire scenario to the adequate protection and post-petition requirements, an incentive is created for the new supplier of finance to choose reorganization, even in cases where this choice is not value-enhancing. Indeed, without adequate protection and post-petition interest payments, the collateral is actually being given for free to the firm.

A possible solution to fight the tendency to reorganize the firm in such a situation—even if reorganization does not create value—would be to require that the value of \$150 be protected against financial and physical depreciation, as a condition for the new supplier of finance to be repaid, but the relevant benefits of such protections should be denied to the secured creditor. In other words, upon liquidation, after the reorganization attempt fails and the assets of the firm are sold for \$130—less than the \$160 that would have been collected had the firm been auctioned at the onset—the new supplier of finance would be able to collect his claim only after the secured creditor is repaid \$130. The unsecured creditors are repaid, first, a sum of \$10, reflecting their initial share had the assets been sold in the auction for \$160; and second, an additional sum of \$20, reflecting the adequate protection requirement plus a market interest accrued over the sum of \$150 (value of the collateral at the beginning), reflecting the post-petition interest requirement. In short, while the new supplier of finance has been subjected to the screening effect of the adequate protection and post-petition interest doctrines, the secured creditor was still denied these protections, and unsecured creditors enjoyed the benefits of these protections in his stead.

V. CONCLUSION

Efficiency in corporate bankruptcy is based upon making good decisions in the redeployment of a distressed firm's assets. Lawmakers and scholars contemplating an appropriate approach for redeployment have ignored an efficient hidden structure for legal rules in corporate bankruptcy settings. The building blocks of that structure have been introduced by this Article. The new approach is based upon the assumption of a certain better positioned agent (BPA) in several of bankruptcy's decision-making contexts, who ought to be entrusted with making a market-oriented redeployment decision. This Article demonstrated the feasibility of the new approach in one such context. I have argued that the Better Positioned Agent approach improves upon the redeployment decisions as it calls for utilization of dominant secured creditors of small- to medium-sized firms to increase wealth by forcing them to monitor the firm or push it into a turnaround effort, even prior to the commencement of a formal bankruptcy procedure. To that end, the protections afforded to such a better positioned secured creditor—adequate protection and post-petition interest—should be denied.

The advent of a Better Positioned Agent is an imperfect solution, much like the two model solutions currently dominating corporate bankruptcy settings worldwide. However, lawmakers need to familiarize themselves with this new solution, as it offers a chance to carefully and knowingly weigh the benefits and shortcomings of each solution, as well as expose bankruptcy's relevant trade-offs. Future research should focus on devising schemes for BPAs other than the dominant secured creditor of a small- to medium-sized firm, e.g., the new finance supplier. Moreover, empirical and theoretical comparisons of all three decision-making models are needed.